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FEDERAL INCOME TAX DEDUCTION FOR STATE AND LOCAL TAXES

HEARING

BEFORE THE

SUBCOMMITTEE ON
INTERGOVERNMENTAL RELATIONS

OF THE

COMMITTEE ON
GOVERNMENTAL AFFAIRS
UNITED STATES SENATE

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FEDERAL INCOME TAX DEDUCTION FOR STATE AND LOCAL TAXES

WEDNESDAY, JUNE 26, 1985

U.S. SENATE,
SUBCOMMITTEE ON INTERGOVERNMENTAL RELATIONS,
COMMITTEE ON GOVERNMENTAL AFFAIRS,
Washington, DC

The subcommittee met at 1:10 p.m. in room SD-342, Dirksen Senate Office Building, Hon. Dave Durenberger (chairman of the subcommittee) presiding.

Present: Senators Durenberger, Cochran, Chiles, and Levin.

OPENING STATEMENT OF SENATOR DURENBERGER

Senator **DURENBERGER**. The hearing will come to order.

This is the first hearing held by a Senate subcommittee on the Federal income tax deduction for State and local taxes and proposals to eliminate or modify it. The deduction has been a provision of the Internal Revenue Code since the creation of the Federal income tax in 1913.

I think that the discussion of this issue early in the debate over tax reform is extremely important. Although I support the goals of tax reform expressed by the President, goals like simplicity, fairness and growth—which no one can argue with—I question the fairness of a proposal which weighs so heavily on the revenue systems of State and local governments. Unless a compromise or agreement is reached soon, the growing opposition to eliminating the State and local tax deduction, as the President proposes, could sidetrack tax reform altogether.

The fact that this hearing is being conducted by the Subcommittee on Intergovernmental Relations is also extremely relevant. The President would have us believe that this deduction is about winners and losers, pitting high tax States against low tax States and high income taxpayers against low income taxpayers. This kind of talk is divisive and inaccurate. It misrepresents the importance of the deduction in our intergovernmental system, and it ignores the basic precepts of federalism which have guided our Nation for 200 years.

State and local governments are not just another interest group protecting their favorite tax loophole. There are fundamental differences between deductions which support legitimate public services like education, health care for the poor, police, and those that support three-martini lunches, country club memberships, and season tickets to professional sports.

Our National, State and local governments are joined in a single system of government, sharing responsibilities and resources. The deduction of State and local taxes helps to preserve the fiscal integrity of State and local governments in this Federal system. The deduction serves to lessen harmful tax competition among States by helping to buffer the effect of fiscal disparities among them. The deduction helps to smooth some of the tensions in our Federal system, not to increase them.

I consider the continuation of the deduction to be the cornerstone of a healthy intergovernmental system. Optimally, I would prefer the deduction be left unchanged. In the interest of broadening the tax base and lowering the tax rates, however, I, for one, am willing to concede that State and local governments should be called upon to make a fair and reasonable contribution to comprehensive income tax reform. But this does not mean elimination of the deduction.

Instead, I have offered a compromise which balances the interests of State and local government with the goals of tax reform. Under my proposal, each itemizing taxpayer could pool his or her State and local taxes and deduct the amount exceeding 1 percent of his or her adjusted gross income.

This proposal respects three basic principles that should be met by any approach to modify the deduction: It helps to lessen fiscal disparities among the States; it treats all States and local governments fairly and respects their revenue-raising decisions; and it contributes to the progressiveness of the federal tax system.

At today's hearing, we will consider the President's proposal to eliminate the State and local tax deduction and its impact on State and local services and taxes. We will also consider alternative proposals to modify the deduction. There will also be further hearings on other related subjects.

Our first witness is not here, but our second witness is sitting right in front of me. Let me call Senator Daniel Patrick Moynihan from the State of New York, my colleague on several key committees. We appreciate very much your being here and your willingness to address the issue in this forum, as well as the forum in which we will both eventually address it, the Finance Committee.

TESTIMONY OF HON. DANIEL PATRICK MOYNIHAN, A U.S. SENATOR FROM THE STATE OF NEW YORK

Senator MOYNIHAN. Thank you, Mr. Chairman. If I am a little out of order, I can go with the thought that I can also be brief, and will. I have a statement which I would like to place in the record and then just to summarize and to respond to your questions.

Senator DURENBERGER. Your full statement will be made part of the record.

Senator MOYNIHAN. Mr. Chairman, I would like to speak this afternoon about a branch of government which is unique to the American political system. As far as I know, nothing like it exists anywhere else in the world. There may be, but I don't know. Sometimes we hardly notice it in our system. It is, in many ways, a sovereign branch of government. They levy taxes, spend large amounts of money, and perform what in many respects is the single most important domestic function that government does perform, and these are, of course, the school boards of the United States.

There are 15,840 school districts in the United States. They are, without exception, chosen by open elections which are nonpartisan. They are unpaid positions, even though of great consequence. We are the only country in the world that assigns education to this nonpolitical, apolitical public device. It is the quietest and most public regarding our operations. They are the quietest and most public regarding all of our operations.

To deny the deductibility of State and local taxes, local taxes, in this case, to the school boards could force local education financing. It would do so with no notice after a century and a half of a holy experience.

I might say, Mr. Chairman, and Senator Cochran, I don't know if I have said this in front of Senator Cochran, but the first income tax was levied in Congress in 1862, a 1-year tax to help finance the Civil War. Justin Smith Morrill of Vermont, the author of the Morrill Act, brought the bill to the floor of the House as chairman of Ways and Means and took great care to see that with this tax, in no way will there be any Federal tax levied on moneys paid to State governments or subdivisions thereof. That would be a fundamental offense of federalism.

Senator **DURENBERGER**. I have to step back from 1913 to 1862.

Senator **MOYNIHAN**. 1862. It has been with us. It is something we have understood from the beginning.

Mr. Chairman, just a few numbers about school finance. First of all, I would like to say that on June 19, the National School Boards Association, which represents 15,840 school districts and 95,000 elected officials, nonpartisan board members, has come out and urged the Congress not to eliminate this deduction.

Can I go through the fairly simple calculations? First of all, I would like to quote a statement by Joan Parent. It sounds like something from a model Reagan speech, but Joan Parent is not Mrs. Joan Parent; she is, in fact, a lady named Parent. She is a former school board member from Foley, MN.

Senator **DURENBERGER**. About 12 miles from where I was born, raised, and educated.

Senator **MOYNIHAN**. You probably know the Parents, Mrs. Parent. She is a former president of the National School Boards Association, and she put the proposition this way: That the provision in the repeal of the deduction, and I quote, "will have the immediate impact of effectively imposing a 40-percent tax on providing services at current levels." It is a 40-percent increase in the cost of local school taxes.

There is a simple proposition here. When tax economists talk about local taxes, they talk about the tax price. Tax price is basically $1 minus the marginal rate of taxation, which is, for the Nation, 28 percent. So, the tax price average in the Nation for a dollar's worth of school taxes is 72 cents. You raise that to $1 and you have increased that 72 cents by 40 percent. That is where Mrs. Parent gets her 40 percent.

These are standard statistics. The Congressional Research Service will tell you what the marginal rate is, what the increased costs would be.

There is another statistic which is not as hard a one, but it generally states that there is an elasticity of demand in local taxes, and if you raise a tax cost by unit 1, you will end up with the public responding by providing 0.5, and that is why Mrs. Parent and the School Board Association say to us that this provision will bring about, over a fairly short period of time, a 20-percent real reduction in outlays for education on a local basis.

Those are real numbers. Any of us who have been, as we all have, as Senator Cochran has, as you have, have been involved in local schools, try to get that bond levy through, try to get the rates raised when these things are statistics. These things come from the stream. They don't come from the national political scene, and they very much respond to costs, real actual costs, costs on the farm, costs in the house, costs in the store.

If we do this, a nonpartisan disinterested set of economists will tell you that you are going to cut outlays for education by 20 percent, just the numbers.

Senator DURENBERGER. Is there a convenient place to break your train of thought so we can let Governor Robb testify? I will leave that to your judgment.

Senator MOYNIHAN. There is a convenient place to break my train of thought, and to conclude my testimony as I was going to do in any event, which is to say that this cut in the State of Minnesota would come to $671 per student per year.

Thank you, Mr. Chairman. I would like to ask that I might enclose the testimony of Ms. Joan Parent,[1] formerly president of the National School Boards Association on this subject, her statement, Ms. Joan Parent of Foley, MN, 12 miles from the former—I would like to think—birthplace of the distinguished chairman of the subcommittee.

Senator DURENBERGER. That is right. Yes; that will be made a part of the record without any indication as to whether or not she was 1 of the 3,170 people that made the difference in Minnesota's distinctive contribution to last year's election. [Laughter.]

I am sure she wouldn't be on that last, anyway. Pat, thank you so much anyway. I appreciate it a lot. I know you have more to say and you have more in your statement. We both will have a lot more to say on this issue in the several committees that we share the issue with. Thank you.

[Senator Moynihan's prepared statement follows:]

PREPARED STATEMENT OF SENATOR MOYNIHAN

One month ago, President Reagan announced his plan to simplify the tax code by, among other things, repealing the current deduction for state and local taxes. Three weeks later, on June 19, the National School Boards Association announced its position that such would seriously undermine the Nation's 15,840 school districts. In so doing, the National School Boards Association joined 18 other national educational organizations in opposing the proposal to end this deduction.

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[1] See p. 113.

The National Association represents some 95,000 elected school board members, from rural, urban and suburban school districts that share only one common interest: the health of public elementary and secondary education. School districts are also our most local level of government, and Federal tax policy is not a matter with which the National Association typically must be concerned. This is different, and the reason is simple: Repeal of the deduction for state and local taxes will likely lead to large reductions in support for public education.

Here's how. School districts rely overwhelmingly on the property tax to finance their operations. This tax is now deductible. If this provision were repealed, every property taxpayer in America would experience a substantial increase in the burden—the true economic cost—of his or her property taxes. The increase in this burden would be substantial—up to 40 percent by reasonable calculations. Joan Parent, a local school board member from Foley, Minnesota and former President of the National School Boards Association, put it this way: "This provision [repeal of the deduction] will have the immediate impact of effectively imposing a 40 percent tax on providing services at *current* levels." [Her emphasis.]

The public finance literature provides some guidelines as to what would happen next. According to the Congressional Research Service, it is likely that over the following few years, half of this sudden increase in the burden of taxes for education would be rolled back. The implications for school finances are ominous. In the 1983-84 school year, we spent about $3,400 per child on public education. If the repeal of deductibility increases the real burden of schools taxes by 40 percent, this suggests that over the following few years average spending per student would decline by half that amount, or some 20 percent. Based on total spending for education from state and local taxes and the numbers of students currently in public schools, this would mean a cut in education spending of some $605 per child.

This will happen everywhere, not just in the so-called high tax states. New York is a high tax state, and could find itself forced to cut education expenditures by some $870 per student. The cut in Minnesota would come to $671 per student. In Delaware, $776 per student; Pennsylvania, $726 per student.

Mr. Chairman, we must not permit this to happen.

Mr. Chairman, may I submit for the record the statement that Joan Parent, from the Foley, Minnesota school board, presented on behalf of the National School Boards Association at a June 13 meeting here in Washington of educators concerned about the effects of the loss of this deduction on public education. I also would like to submit for the record a statement and analysis I offered on June 12 on the impact of this proposal on school financing in each state. Thank you, Mr. Chairman.

Senator Durenberger. Governor Robb, Chuck Robb is here today. Al, do you want to both come up here and be on television together? [Laughter.]

We do have an order and the Governor was first, but we took Pat ahead of him.

Governor Robb. Mr. Chairman, I certainly wouldn't want to break up New York under any circumstances.

Senator Durenberger. My gosh, is that noble. Al, get up here real fast. Thank you.

Senator D'Amato. I wanted the Governor up here to find out what side of the coin he is on.

Senator Durenberger. I think everyone is on the same side so far. Al D'Amato, champion of the people, we welcome you here. Your full statement will be made a part of the record.

TESTIMONY OF HON. ALFONSE D'AMATO, A U.S. SENATOR FROM THE STATE OF NEW YORK

Senator D'Amato. Mr. Chairman, I appreciate the fact that you are holding these hearings to consider the implications of Treasury II and more specifically, to look at the issue which you have been a leader in: What impact and what effect will doing away with the deductibility of State and local taxes have on our Nation?

I have heard a lot about fairness, about the progrowth and profamily; how, my gosh, the only thing they haven't put in Treasury II is apple pie and the American flag.

Everyone is for fairness. Everyone is for tax equity. I think the thing that cries out most is that middle income people are upset about large companies and wealthy people escaping taxation.

I have heard Americans, many, many throughout this country complain about the unfairness that they see when large corporations and wealthy individuals pay little, if any, tax. You cannot justify corporate America or wealthy individuals escaping the payment of their fair share of taxes, whether it be the great corporate giant General Electric from my State, a great company.

But how do you justify earning billions of dollars and not paying 1 penny in taxes? The list of companies who have avoided payment of taxes as a result of the code is one which I think enrages people when they see it and they hear it, and they say, "We want them to pay their fair share." That is the engine that pushes and pulls that cry so that people say, "Let's have that simplification." Really, what they are saying is tax fairness and to avoid the kinds of things where people escape paying their fair share.

So somehow, someone down at Treasury, in order to come about with a program that is going to lower rates, comes up with a program which says that suddenly, suddenly, there is something wrong with citizens being able to deduct their State and local taxes. I don't know why it has never been wrong before. But, of course, the answer is simple: It has nothing to do with fairness or equity, absolutely nothing. But someone was able to figure out that there are maybe 10, 12, 14, or 15 States that are impacted that lose revenues, and that on a simple numbers basis, therefore, we should be able to get through this bill and it will pick up anywhere from $35 to $40 billion in revenue from the citizens, not the States, the citizens, the people, the working families who live in these States.

They will be disadvantaged, and this can help lower the tax rates. After all, it is always nice to say to people, "We are going to lower your tax dues, and that is what this bill does." It is superficial in that aspect in that it places a double tax on people, a tax on local moneys that people are forced to pay to the school districts, to their towns, to their communities, to their sewage districts, to the State government for the essential services that the States must pay. For the first time, they will be paying taxes on taxes, double taxation.

I find it absolutely intriguing, Mr. Chairman, that under the guise of tax simplification we can say to working class American families who, for the most part, understand the greatest resource they will ever have in their lifetime, their house, their home, that we are now going to say that the local property taxes that they pay to their schools, to their towns, to their communities, that they have no say about it? They must pay taxes upon taxes. They are not going to be able to deduct that.

What will happen to the value of their homes? The value of their homes, Mr. Chairman, can't help but be adversely impacted, and depending upon how high that tax is in certain areas, could cost them, that homeowner, 4 percent to 14 percent of the value of his or her home. We haven't even talked about the economic impact in terms of how many jobs will be lost in the future and the fact that homeownership will be less desirable.

I think most Americans don't realize that that is what this tax bill would do, take away the right for them to deduct their local property taxes, because they were so concerned when tax reform first came up that they be allowed to preserve the deductibility, an increase on the mortgage on the first home, that when they heard that that was done, they completely put aside the question of their first home being impacted by this tax legislation. Most of them do not realize at this date that this legislation would do away with their ability to deduct local property taxes paid on their home.

I have, Mr. Chairman, one other point to make. It seems that Treasury has set up two classes now for all times, and if this proposal is passed, I think, as intended, it makes taxpayers who pay taxes to any of the 50 States, to any of the 50 States or local governments in the United States, second-class citizens. Because what this bill says, is that if you pay taxes to a foreign government, to the Japanese Government, if you are an individual or if you are a corporation, you can take a tax credit. Most Americans have a difficult time knowing what a tax credit is. That is better than a deduction. That is at least twice as good as deduction. It means that if a bank pays $100 million in taxes to Japan, then the bank can reduce its U.S. taxes by $100 million. A credit reduces tax liability and a deduction only reduces taxable income. Treasury preserves the foreign tax credit, but repeals the domestic State and local tax deduction.

So, if you pay taxes to a foreign government, that is terrific. We encourage you to do that if you are a corporation by allowing a reduction in U.S. taxes through the foreign tax credit. If you are a bank or if you are a corporation in 1980, there were 22 billion dollars' worth of foreign tax credits. But if you are a citizen paying taxes to any of the jurisdictions in the United States of America, any of the 50 States, any of the local governments, you will no longer be able to deduct.

Now, that is not fairness. Are we really saying to the American citizens that you are better off paying taxes to a foreign government because you can get a tax credit, but if you pay taxes to the State of Minnesota, the State of Mississippi, to any of the cities, then you can't ever get a tax deduction. This is unfair.

I suggest there is something, too, that flies in the face of federalism, and it begins to play which State comes out a little better at someone else's expense. It may be that there may be some temporary winners in this game of pitting State against State and region against region, but I suggest to you that that is temporary, and I suggest to you that when we talk about the needs of our States collectively and its people, that this particular provision flies in the face of fairness, and it does irrevocable harm to that which is so important in our system of democracy today.

Mr. Chairman, I thank you for giving me the opportunity of sharing some of these thoughts with you, and I commend you for holding these hearings.

Senator **Durenberger**. I thank you. I would just make the observation that there is one more thing that most Americans don't understand, and that is that Alfonse D'Amato came to the U.S.

Senate from the position of town supervisor of the largest town in the United States of America, the town of Hempstead, N.Y., so you know whereof you speak.

Senator D'AMATO. That is right, and I know that those taxpayers—and they are middle-income wage earners for the most part—are going to be severely impacted. It is a residential community in nature, 800,000 people, 220,000 homes, all single- and two-family homes, and as I said to you, those are the people who work, pay their taxes, and they continue to complain about it. But they do cry out, even in the town of Hempstead for tax fairness. If we want to do something, let's pass a real corporate and individual minimum tax and raise some revenues there, and then if you want to increase the deductions for working families and do away with the marriage penalty that is a penalty for working families, I think that makes some sense.

Senator DURENBERGER. Thank you very much, Al.

[Senator D'Amato's prepared statement follows:]

PREPARED STATEMENT OF SENATOR D'AMATO

Mr. Chairman, I commend you for calling this hearing and taking a leadership position on the issue of state and local tax deductibility.

Repeal of the State and local tax deduction has so many ramifications that it is difficult to know where to begin the discussion.

I could describe the impact of repeal on U.S. citizens. According to Treasury data, over 33 million people will lose $35 billion from loss of the deduction for State and local taxes. 28 million of these people make between $22,000 and $40,000. These are middle-income families that cannot afford to pay more in taxes.

These people will watch the equity in their homes disappear if deductibility is repealed, but repeal has even further implications.

For instance, how will our local schools raise money? Certainly we would rather have education funded and managed at the local level than through direct Federal appropriations. Will this be possible if school districts become unable to raise the revenues necessary to maintain education excellence because their tax base is eroded through elimination of the deduction for property taxes?

If I may, Mr. Chairman, I would like to focus on one specific area in talking about State and local tax deductibility: fairness.

Why are we embarking on tax reform? Because the people believe that the current system is unfair. The people are right. They are mad that individuals who earn identical incomes are taxed at widely varying rates. More to the point, middle-income taxpayers are tired of paying their fair share, while the companies they work for pay no taxes on billions of dollars of income.

This is no secret. Even Treasury knows that the essence of tax reform is fairness. But, armed with that knowledge, Treasury has proposed a tax system that creates a new inequity: double taxation.

Mr. Chairman, I would not be so vocal in my criticism if Treasury proposed that all taxpayers incur double taxation. But Treasury believes that people paying taxes to their local school system should pay Federal taxes on that money, i.e., incur double taxation, while companies and individuals paying taxes to foreign governments should receive a tax credit for these payments—not a deduction, but a credit.

Treasury bureaucrats believe that individuals should be forced to pay taxes on taxes. This would be accomplished by repealing the deduction for State and local taxes.

Interestingly, however, these same Treasury bureaucrats do not believe that corporations should bear the burden of double taxation. Treasury has proposed that companies be relieved from double taxation.

First, Treasury would preserve the foreign tax credit with only small modifications. In short, Treasury says that a company should get a break on its U.S. taxes if it pays any taxes to Japan.

This is disgraceful. Treasury claims that their purpose is neutrality in the tax code. But then they propose that people and corporations be treated differently.

On top of this, Treasury also proposes that companies be partially relieved of double taxation on the dividends they pay. This would be accomplished by allowing companies to deduct 10 percent of their dividends paid to stockholders from their corporate income.

If we are going to have a chance at enacting major tax reform, the public must perceive it as fair. Treasury's plan is not fair and the people know it. There is no way that Treasury's plan can be called fair when average Americans incur double taxation and corporations paying taxes overseas receive preferential treatment.

I will do all I can to insure that U.S. citizens are protected from double taxation. Mr. Chairman, I am pleased that you have joined me in this fight.

Thank you, Mr. Chairman.

Senator **DURENBERGER**. Thad?

Senator **COCHRAN**. Mr. Chairman, I want to join you in congratulating Senator D'Amato for being here and taking a leading role on this issue. As usual, he is out front and effective. So it is good to see you here before the committee.

Senator **D'AMATO**. Thank you, Senator.

Senator **DURENBERGER**. Thank you, Al.

Senator **D'AMATO**. Thank you, Mr. Chairman.

Senator **DURENBERGER**. Our next witness is the Governor of the Commonwealth of Virginia, Mr. Chuck Robb, who has been very helpful to this committee before, an executive member of the committee of the National Governors Association, president of the Council of the States, and chairman of the Education Commission of the States.

One other Governor could not be here, Governor Herschler of the State of Wyoming. He can't be here, but he is submitting a written statement [1] in which he will express his support for retaining the deductibility of States and local taxes.

Senator **DURENBERGER**. It came as a surprise to me, and maybe it does to other people, that Wyoming, which benefits the least from deductibility, has a Governor with the kind of understanding that Governor Heschler has. He believes that deductibility is not really a battle between high-tax and low-tax States. It is the much larger issue of federalism, that is, protecting the right of States to raise the revenues they need in ways which make sense to the individual State.

I thought I would say that as a summary comment in my introduction of Mr. Chuck Robb. We are very pleased to have you here today. Your full statement will be made a part of the record. Appearing with you is Mr. Ray Scheppach, executive director of the National Governors' Association.

TESTIMONY OF HON. CHARLES S. ROBB, GOVERNOR OF THE COMMONWEALTH OF VIRGINIA, REPRESENTING THE NATIONAL GOVERNORS' ASSOCIATION

Governor **ROBB**. Thank you, Mr. Chairman. I appreciate very much the opportunity to be with you today. Let me begin by expressing on behalf of all of us who labor in the vineyard of either State or local government that we are particularly appreciative of your ongoing concern for those special relationships and understanding and a sophistication of that understanding which many of us have benefited from in a variety of other contexts.

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[1] See p. 118.

I think it is only appropriate that when we have someone that seems to understand us that we probably ought to say so as much as we can.

Senator **Durenberger**. Thank you.

Governor **Robb**. I appreciate the opportunity to be with you and with Senator Cochran and any of the other members who are present here today to present the National Governors' Association official position on tax reform, particularly with respect to the issue which you have called this particular subcommittee meeting for, State and local tax deductibility.

Before summarizing the lengthier testimony which I will submit for the record, I wish to indicate that the NGA tax policy was adopted by a two-thirds vote of the Nation's Governors and that policy, therefore, does not necessarily represent the view of every individual Governor. Again, this summer, that particular question will be on our agenda when we convene in Boise, ID, to consider a number of matters, not the least of which is the question which is before your subcommittee, Mr. Chairman.

Admittedly, some Governors have taken a position which is not consistent with the current NGA policy position, and we may well hear from others before this debate is concluded. I have personally indicated that I have an open mind as to a number of alternatives that are before this subcommittee, one of which, Mr. Chairman, is the one which you have proposed and in which all of us have read about in some detail, thanks to your authorship on that particular question.

To begin with, clearly, Governors, like most Americans across the country, favor some form of tax reform, and we applaud the President and we applaud the Congress for the leadership that has been exhibited recently on this particular issue. I think all of us would agree that the present system is complex, inefficient, and unfair.

We further believe that a modified flat tax that broadens the tax base is the alternative for strengthening the Federal tax system.

Such a change would permit a reduction in tax rates and enhance incentives to work, save and to invest. These advantages also will be reflected in most State income tax systems, since States generally follow the Federal definition of income.

With respect to the issue of State and local tax deductibility, the Governors are certainly willing to consider some limited modifications, and some of us are perhaps prepared to go further, but only in the context that base-broadening is significant. Regrettably, even though we applaud the President's leadership, the administration's current plan does not successfully meet that test. The NGA believes that the efficacy of almost eliminating State and local tax deductibility should not be debated on the grounds of winners and losers among States.

There has never been a clear-cut Federal policy in the United States to equalize the distribution of income across States. The NGA believes that to single out State and local tax deductibility as the only redistribution component of Federal policy is simply inconsistent with the long-held values of market reliance and diversity.

Such an approach distorts the real public policy issues of equity, fairness, and federalism, and I would like to speak briefly to those.

For most Governors, certainly, the first issue is equity. The State and local tax deduction is used, as you have pointed out repeatedly, by more people than any other in the Federal code, more than for charitable contributions or for medical expenses or for home mortgage interest. In Alaska, 39 percent used this deduction, in Utah, 58 percent, in Virginia, 41 percent. It is not a deduction that goes primarily to a privileged class of wealthy taxpayers.

This is primarily a deduction for middle America, for those families where both husband and wife work, own a home and who pay most of the Federal, State, and local tax burden. Few of these middle income families have capital gains, real estate shelters, or special oil and gas tax preferences, deductions that have all been maintained under the current plan.

For example, only 7 percent benefit from the special treatment of capital gains, and fewer than 1 percent benefit from either the foreign tax credit, as was pointed out just a moment ago, or intangible drilling costs. In summary, the elimination of State and local tax deductibility hits hard on middle-income Americans, the group that works hard and carries most of the Nation's tax burden.

Concerning fairness, deductibility of State and local taxes represents $33.2 billion or only 11 percent of the $293 billion total of all current deductions and exemptions in the individual income tax or tax expenditures, as we often refer to them. The administration's recommendation is that the revenue gain from modification of all individual tax expenditures would total $49.4 billion. Thus, State and local tax deductibility represents 67 percent of the administration's tax expenditure modification but only 11 percent of the current total.

I can certainly assure you, as I know that you well know, that the States are not special pleaders, and we are certainly very much prepared to do our part. However, a plan which asks State and local government, the partners in the Federal system, to bear 67 percent of the burden while continuing over $243 billion in special exemptions and deductions for every special interest group from life insurance and real estate to the oil industry is simply not tax reform however valuable and however justified any of those might or might not prove to be.

The question of federalism: the elimination of State and local tax deductibility will clearly errode the ability of State and local governments to fund their increasing needs over the next decade. State and local governments are going to be facing significant demands for additional investment, just in the programs for which they are currently responsible. Demands that were deferred earlier in this decade, particularly during the recession, and growing needs by 1990 are going to require new, annual expenditures of more than $65 billion by state and local governments.

These additional expenditures will include, for instance: $13.6 billion to fund an expanding demand for health care, particularly in the increasing aged population; $15.4 billion for services to a larger school-age population; and improved elementary and secondary education; $16.4 billion for restoring and maintaining the Federal, State, and local highway system; and $15.3 billion for hazardous waste, wastewater treatment and water supply facilities.

Not only are the needs of State and local government increasing, but it is important to point out that most expenditures for these levels of government are investments that are critical to the Nation's long term economic growth.

Curtailment of these expenditures will have a substantial, long-run, negative impact. State and local governments have already paid a heavy price in terms of lost Federal aid. By the end of this fiscal year, grants will have been reduced by about 40 percent since 1980. Governors have to point out that their States have already absorbed a large share of the deficit reduction, and I am sure that will be pointed out by Mayor Leafe, testifying on behalf of the cities.

It now appears that they have been singled out again to pay the price of tax reform by restricting their ability to raise revenues, to meet both emerging needs and to offset some of the Federal reductions in domestic programs.

In conclusion, Mr. Chairman, the Governors support meaningful tax reform that follows the general guidelines of broadening the base and reducing marginal tax rates. They are definitely willing to consider some modifications of state and local tax deductibility as part of a comprehensive tax reform plan.

But the total elimination of deductibility is simply inconsistent with the Governors' current policy position. An alternative which appears to be consistent with NGA policy, Mr. Chairman, is your suggestion that deductibility be limited to only that which is over 1 percent of the adjusted gross income.

In summary, the States are a central part of the Federal system and are prepared to make a substantial contribution to the deficit reduction as well as tax reform, and I might add that I hope that neither the former or the latter gets lost in this particular debate. We are very much concerned that the tax reform, like deficit reduction, will somehow slip beyond the reach of Congress and all too soon, unless the parties are all able to put something on the table and unite behind a single plan.

I can assure you, on behalf of the States, the States are prepared to do their share.

The Governors are not special pleaders, but partners in the Federal system. They cannot shoulder the full burden, but look forward to working with you and with the subcommittee in helping to put our Federal financial house in order.

Mr. Chairman, I thank you very much. I have extended remarks which I, indeed, will submit for the record. I would be pleased to respond to any questions that you might have, although I suspect that you could give most of the same lecture and a whole lot more and have for many years. Again, for that we thank you. We appreciate it.

Senator DURENBERGER. Let me ask you a question from your practical experience. We can ask it of you since by force or constitution, you have to leave office, so you have to be very honest. [Laughter.]

Governor ROBB. I would hope the implicit suggestion that I have not been previously would not be a part of the record.

Senator **Durenberger**. We can eliminate the whole observation. [Laughter.]

We seem to be living in a time right now where several things are going on in this Federal-State relationship. There is, in fact, a real devolution of responsibilities, and a lot of people welcome that; even Governors welcome that; people in the local government welcome that.

There is somewhat less—and I can save this for Ron Pearlman when he gets up here—this seems to be somewhat less of a devolution of tax sources. In other words, we are still going after cigarettes and gasoline and a variety of other things. We really haven't let up on the tax source side of it.

Governor **Robb**. Mr. Chairman, we have noticed. [Laughter.]

Senator **Durenberger**. I hope you have. But at the same time, coming off the bad economic times of the early part of this decade, a lot of States have raised taxes. My State will testify here the degree to which they have been successful in cutting them. But still, the projections out there seem to be that States aren't going to do so badly for the next 5-some years in a generally good economic climate. So in effect, the question is, what is to worry about in the loss of deductibility?

We heard from Pat Moynihan and we are going to hear the National Education Association talk about a 20-percent reduction in State financing for education. Are these real figures? Are those real concerns? Does that fit with your view of the real world in Virginia as you look at it over the next 5 years?

Governor **Robb**. Mr. Chairman, those are real concerns. I would have to suggest to you that if, indeed, the economy were going to be a perfect economy for the next 5 years, we probably would be less concerned as, indeed, the Federal Government could be less concerned. We could all believe, as we would like to believe, that the rosiest of economic predictions over that period of time will obtain and that all the benefits that would flow from a growing economy, et cetera, would be part of an equation.

There are some of us who are a bit more skeptical when we look at what is outlined as a continued growth under the current situation, particularly if we don't adequately address the Federal deficit question, the balance of trade question, the long-term interest rate question, et cetera. I won't get up on my soap box on that particular question.

But suffice it to say that the needs are real. What I was talking about a few minutes ago are, in many cases, deferred needs. During the period of exceptional financial stress for all of the States, and Virginia is one of the very, very few that did not have to raise any general taxes during that period, 40-some States in the years 1982 and 1983 alone had to raise taxes. But some now are be able to make adjustments. We were one of the very few that didn't, but it was pretty close.

As a matter of fact, at this time 2 years ago, as we ended the fiscal year, I was counting down with the comptroller and others to make sure that we would end up in the black, as indeed, the constitution requires.

We have made this point repeatedly to the President and to others in Treasury and the executive branch, who had looked at a series of projected excesses, in many cases, in special or limited or dedicated trust funds within the States and said, "Well, the States have a great big pot of money, and the Federal Government is in dire straits. Why don't we just transfer the burdens on that basis?"

We are willing to accept the continued devolution of Federal responsibility as we have, and as you pointed out, many of us think this is good if you will not—and this is the point I think that you really want me to address—as long as you don't find a way to prevent us from being able to respond to those needs when they arise.

These deferred needs, in all of the infrastructure questions that have not been adequately addressed, we have a number of needs in areas that are perhaps more visible: highways and bridges that are State responsibilities or the maintenance are principally State responsibilities at this time; in another, wastewater treatment, where the Federal match is decreasing. A tremendous amount of unmet need is accumulating and simply sustaining the present infrastructure is difficult without any regard to financing future improvements in those particular areas.

We need to have a viable base. One of the things that I have continued to point out in Virginia during the same period of time, and I have resisted the temptation to increase taxes but have cut spending and used level funding in a lot of budget, has been our need to preserve our capacity to meet future needs.

The only way we can do that is to preserve the kind of flexibility and, for many States, the ability to raise taxes to meet needs, and for local governments, too.

Some have local income taxes; most depend largely on the property tax. But that capacity depends on the Federal Government leaving enough leeway, and part of that comes through the deductibility of State and local income taxes. So we are willing. That is the reason we think that your proposal is particularly sensitive to this leeway for future need. It goes in the direction we think we can go in this regard.

I won't get off on another tangent, but many of us would like to have seen an even cleaner bill in terms of what was presented, recognizing that the give-and-take of the debates during the political process will require some concessions along the line.

But we can't take all of the revenue at the Federal level and expect the States and local governments and a proper devolution of Federal responsibilities in some areas, and again, many of us would like to reopen the debate in terms of a negotiated federalism. We are not going to be able to do that and meet those needs, whether they are a process of negotiated federalism or simple devolution, if we don't have some capacity to raise those revenues. That goes, I think, directly to the heart of what you have identified as a real concern for the states and again, we appreciate it.

Senator **DURENBERGER**. One of the ironies of the tax reform proposal is that the deductibility is not lost compared to business. It is lost with regard to individuals. I won't explore the theory, but I think the theory is that one expense of doing business is paying state and local taxes. I tend to think that part of the expense of earning income is undertaking the obligation of paying tax on that income, also. However, I am a little vague on that. Ron, store that one away and you can come back with your response to that one. Is it possible that what we will see is a shift from taxes on individuals, income consumption, and property to heavier State and local taxes over more heavily onto businesses?

Governor **Robb**. That certainly is one. I mean, when the pressure becomes too great in one level, we are all a part of the political process, and there is a tendency to look, as, indeed, a suggestion about the thrust of the current Federal proposal, shift some of that burden from individuals to the business community. Ultimately, whether the business community pays it up front, the consumer, the ultimate taxpayer, is going to have to foot the bill as higher prices of goods that are delivered through services and manufactured goods.

Whatever the case may be, certainly, that is one of the areas that the pressure is likely to go.

Senator **Durenberger**. If that happens, we accentuate the disparity and the economic competition that exists among the states.

Governor **Robb**. Indeed.

Senator **Durenberger**. Thad?

Senator **Cochran**. Thank you, Mr. Chairman. As I was listening to your testimony, Governor Robb, I thought I heard the statement that the National Governors' Associations' position wasn't one of objecting to the elimination of the deductibility of State and local taxes unless it was singled out; unless State and local governments were being singled out for the purpose of revenue enhancement or of increasing revenue. Is that correct?

Governor **Robb**. The concern here is that 11 percent of the total tax expenditure question, if you will, is being singled out to provide 67 percent of the solution is what it really amounts to. We are in favor of tax reform, base broadening, and we are willing to make a substantial contribution from those sources that are of particular benefit to the State in any part of the equation. We have in the past. As you know, what is called discretionary spending is really what comes to the states in terms of the revenues that State and local government can handle.

But we are saying, don't try to solve the problem entirely by coming to the one area that may appear to be easiest to solve this particular problem. Put it in a larger equation. Some of us, as I say, I am willing to take an even broader view of the whole equation and to put that on the table.

But it seems to me that we have to, everybody has to put something on the table if we are going to be successful, and this solution seems to be disproportionately weighed in the extreme to picking up this one particular element of the equation in the deductibility of State and local income taxes, $33.2 billion out of $46 billion.

That doesn't look, to us, to be fair. It solves a problem at the Federal level, but it exacerbates a very difficult problem at the State and local level, in much the same way that the elimination of the Federal revenue sharing, particularly through the tasks of localities that I am sure will be addressed in more detail has a disproportionate burden on local government.

Senator **Cochran**. The testimony on behalf of the National Governors' Association is not in opposition to real tax reform, rate reduction?

Governor **Robb**. No, sir.

Senator COCHRAN. But only in opposition to single out this provision to help make it revenue neutral?

Governor ROBB. Yes, sir, that is correct, and what I am saying is that evenwithin our current policy, which may well be refined at our upcoming meeting to reflect the debate that is going on right now, because there is a heightened awareness of the need to be even more specific about this particular question. But even now, the proposal that the chairman of the subcommittee has made is not inconsistent with NGA policy. Again, it is sensitive to those concerns, and this or other solutions that encompass the concerns that the States and local governments have as partners in this whole question of federalism, we think, are critical.

There are differences between individual Governors as to how far they would go under any particular approach, but if you can unite at the Federal level behind an approach which accomplishes this base broadening and overall rate reduction under any reasonably equitable plan that doesn't so obviously violate the basic principles of federalism, you will find many of us willing to come; we will come halfway or more to meet you, because we recognize the need for tax reform.

We also recognize the need for deficit reduction. I won't get off on that issue right now.

Senator COCHRAN. You are also personally for real rate reduction, are you not?

Governor ROBB. That is correct, yes, sir.

Senator COCHRAN. You wouldn't object, then, to infusion—

Governor ROBB. But in other words, real rate reduction which is—let me suggest if at this time only real rate reduction and we don't have a significant simplification of the whole tax question, if we don't address the whole question of tax expenditures in a significant way, the bottom line is we are exacerbating the deficit question, and we don't want to do that. So rate reduction accompanied by genuine tax reform, yes.

Senator COCHRAN. If we had the entire bill approved, though, and eliminated the State and local deductibility reduction——

Governor ROBB. You don't have a bill left.

Senator COCHRAN [continuing]. That will be a $38 billion loss of revenue.

Governor ROBB. That is what we are saying. Let me just say again, because I don't want to be inconsistent. I have said in other forums that personally, since the whole question of deductibility of State and local taxes is a very important card to play and you can play that in one of two arenas: you can play it in deficit reduction, or you can play it in tax reform.

My own personal choice, and this is not NGA policy. As a matter of fact, it is inconsistent. It is specifically opposed by the current NGA policy, but I prefer to see it played on the deficit reduction side, simply because I see the current plan as amalgamation of what appear to be the most politically workable solutions to exacerbate both problems, real tax reform, tax simplification on the one hand, and deficit reduction on the other, I see, as kind of picking and choosing the easy parts that you can only play in one of the two games.

When that happens, I see a serious problem, if we take all the easy cards and play them in a hand that really doesn't accomplish either one. But that is a separate view, and that is not NGA position, I have to tell you.

Senator COCHRAN. Mr. Chairman, thank you very much. I appreciate the Governor being here and his testimony before the committee. I think it has been helpful to the committee.

Governor ROBB. Thank you.

Senator DURENBERGER. One way to express this perception is to consider total tax expenditures. Revenue loss from tax expenditures this year is about $265 billion. Of that, the deductibility of State and local taxes is $31.5 billion, which is about 9 percent of the total.

Governor ROBB. In that ballpark.

Senator DURENBERGER. Of all the base-broadening on the individual income tax, 67 percent of it comes from deductibility; only a third of it comes from the changes in interest and other provisions. Senator Chiles.

Senator CHILES. Governor Robb, we are delighted to have you here testifying on behalf of the National Governors and to get your views on this. You mentioned that the Governors will vote on this issue this summer. How will that work? Can you tell us what kind of process and what kind of statement will that be?

Governor ROBB. Senator, let me begin by answering a question you didn't ask, or make a statement, and that is that I personally apologize. I was going to have the opportunity to meet with you, but I participated in one of the—and I think it is a clear understatement to say—the liveliest exchanges between Senate colleagues that I have ever seen or observed in other testimony that I gave with respect to an airport transfer question earlier on this morning. The word may have already permeated other areas. Suffice it to say, I apologize for not being able to get together with you on matters of mutual interest.

To come back to your question, how does NGA policy evolve? I would like to say that Governors, because of whatever powers and insights they have, are able to resolve questions in a very statesmanlike way, reflecting the, whatever might be involved. Regretably, I have to say that it is very much like the process in the legislature. When you get 50 State Governors together, we tend to debate, put forward, but the actual process involves submitting a resolution and two-thirds of the Governors who are in attendance have to approve a change in NGA policy.

So the burden of change is on those who propose any particular change. I didn't mean to imply that there would necessarily be a change.

I simply wanted to indicate that because this is such a hot topic now within the Nation and within the individual States in terms of debate, that I am certain it will be on the agenda. We already have some resolutions that are addressed to this question.

Whether or not there will be an official change in policy or position, I don't know. I know that there are some of us who are looking for a little bit more breathing room. We may or may not take that on our own. I am here, however, at the request of the NGA, and lest I go far astray, Ray Scheppach, our executive director, who as I think all of you know, is the former Deputy Director of the CBO, that hallowed bipartisan group that always comes up with right answers on economics and taxes.

So he has brought to the Governors' Association a specialized expertise in work with the federal budget.

Senator CHILES. I suspect you will find, Governor, that there are more Senators that are somewhat open-minded on this question of whether State and local taxes should be deducted than you will find on airport transfer. [Laughter.]

Governor ROBB. Senator, I wouldn't touch that one after today's exchange on a bet.

Senator CHILES. Governor, I think that one of the concerns that we do have, or that I know many of us have is if this is adopted, what will be the effects, short-run and long-run, of how this will affect the States and the services they provide, the interrelationship between states, and what will happen in that regard?

This is an item, to my understanding, that the deduction has been allowed since 1913, when we first started doing something on the income tax. Certainly, there can be some kind of shifts or effects on that.

Has your group done any studies as to what the relationship will be or what the changes will be, what the effects will be?

Governor ROBB. Senator, there have been, and if there are some specifics that I don't come quickly to mind, I will ask Ray if he will suggest any particular studies in that area. I do know, and one of the things I mentioned, I believe just before you came in, is our concern that we don't want to have this the single element of an attempt to equalize taxes across state lines. In other words, there has not been a consistent Federal policy in this regard, and we don't think that the elimination of the deductible for State and local taxes ought to be a vehicle for the Federal Government without formally considering it as a major policy change, and we wanted to have an opportunity to address that topic at the appropriate time.

Senator CHILES. Florida, according to some of the numbers I have seen, does not appear to fall today in one of the so-called high-tax States. Florida is not one of the particular high-tax States.

On the other hand, if this provision is adopted, if that means that people will move from the high-tax States into the lower-tax States, I can tell you, 8,000 people a week is about all we need down there in Florida. So we are not looking to accelerate that any.

Governor ROBB. I am familiar with the basic demographic profile.

Senator CHILES. I guess we would have to study; we would like to know who will be coming if they leave. [Laughter.]

If it is the wealthiest that would be coming, we don't always get that mix now. Maybe that is something that we would have to consider.

Governor ROBB. I understand the concern. Ray reminds me that the NGA is currently doing a study that may give some answers in this particular area. But the more important question here, I guess, has to do with federalism generally. I think you know the basic position, because your Governor and myself and many of the others have discussed it on any number of occasions, and we have, as well.

We would like to see, as I mentioned a moment ago, a negotiated federalism debate in which we separated, under some logical rationale, the various services that are delivered at various levels of government, and we think that one of those areas that is appropriate for continued and/or consolidation at the national level is the question of income maintenance, income support, in addition to national defense spending.

The Governors, as you know, have maintained pretty consistently that we are prepared to take an even bigger percentage of spending for education, and the Federal component is reasonably limited there now; a bigger percentage, all, as a matter of fact, of highways, education, the corrections system, all of these traditional systems where there is a stronger State or State and local nexus if we can sort that out, which might have the effect of neutralizing our concern about the particular profile in terms of demographics of those 8,000 a week or whatever it is that might want to come down to enjoy your citrus and sunny beaches in Florida.

We have a way to address that if we can ever get that debate started again.

Senator CHILES. Perhaps we have been negotiating some of that for you in your absence, the Governors' absence, prior to the time that our negotiations broke up on the budget. We were negotiating certain things like taking away revenue sharing after 1986, and major cuts in community development block grants, UDAG, the——

Governor ROBB. With all due respect, Senator——

Senator CHILES [continuing]. Rural Housing Program.

Governor ROBB [continuing]. It has been a largely unilateral debate of late on some of those questions, but we are more than willing to enter it if given an opportunity.

Senator CHILES. Well, I just point out that in all of these areas, the Federal Government's largess to the States is being cut back or the sharing of the federalism is being cut back, and any information that you all have as to what you see the impact of this would be on education and on some of the other areas—education has been cut from about 10 percent to 6 percent, I believe, since 1980, the Federal share, Federal Government's share in education.

Governor ROBB. To the extent we are talking about either categoricals or block grants that go specifically to education and to the extent that that drives up our costs. Our most immediate concern, will be for those specific groups in the population that would be the first losers, the special populations, if you will.

Many of us think to the extent the Federal Government maintains a role in education, that it ought to be continued to guarantee access and to continue to provide for some of those special populations and to continue to provide basic research, particularly in defense and defense-related industries where the incentive for either state or private sector work is essentially diminimum without some Federal incentive.

Beyond that, we are not asking for an increase in the Federal role in education, and I say that in my full capacity as the chairman of the Education Commission of the States. We are willing to work in that arena and others.

Again, we can go back to basic debate. I do think your question about what is the impact and what would be the impact is, indeed, an appropriate one, that we ought to be able to give you some additional information, and I will ask Ray Scheppach, who is the executive director of that organization, to provide all of the various demographics and the impact-type information we can that might assist you in wrestling with this question. I can't give you it off my head.

Senator CHILES. Thank you. Thank you, Mr. Chairman.

Senator DURENBERGER. Thank you, Governor, very much.

Governor ROBB. Thank you, Mr. Chairman and members of the committee. We will be pleased to provide any additional information that the committee might desire, and I thank you.

Senator DURENBERGER. Thank you.

[Governor Robb's prepared statement follows:]

PREPARED STATMENT OF GOVERNOR CHARLES S. ROBB

Mr. Chairman and Members of the Subcommittee, I am pleased to appear before you today to represent the National Governors' Association's position on tax reform, particularly with respect to the issue of state and local tax deductibility.

Let me emphasize that the NGA Tax Policy was adopted by a two-thirds vote of the nation's Governors. The policy does not obviously represent the views of every individual Governor. Some have differed publicly with this policy. I personally have indicated that I have an open mind as to a number of alternatives before this subcommittee; one of which, Mr. Chairman, you have proposed.

In my remarks this afternoon, I would like to focus on the following four issues:

- The Governors' federal tax reform policy
- The evaluative criteria - fairness, efficiency, equity and federalism
- The potential short-run and long-run impacts of ending this tax deduction, and
- The acceptability of alternative modifications in the federal tax treatment of state and local taxes.

Federal Tax Reform Policy

The Governors have a strong interest in the efficiency, fairness, and revenue-raising capacity of the federal tax system. Federal tax policy is critical to national productivity and job creation and, thus, to the growth in output and real income. These in turn have a direct effect on the growth in state tax revenues. In addition, state tax policy is closely linked to federal policy; 35 states currently use either federal adjusted gross income, federal taxable income, or federal tax liability as the state tax base for personal income taxes.

The current system, however, suffers from three basic problems: It is complex, inefficient, and unfair. Most of these problems are linked to the existence of the $293 billion in so-called "tax expenditures" which have become part of the individual income tax. A modified flat tax that broadens the tax base is the best alternative for strengthening the federal tax system. It would allow a significant reduction in tax rates which would have a positive impact on incentives to work, save, and invest. These advantages will also be reflected in most state income tax systems since states generally follow federal definitions of income.

With respect to the issue of deductibility, the Governors are willing to consider some limited modifications, but only in the context that the proposed base-broadening is significant. The Governors' position is that the Administration's current plan does not successfully meet that test.

The Evaluative Criteria

First, the efficacy of eliminating state and local tax deductibility should not be debated on the grounds of winners and losers across states. With the exception of a limited number of federal grants, there has never been a clear-cut federal policy in the United States to equalize the distribution of income across states through fiscal policy — that is, the spending and taxing authority of the federal government. Such a policy is followed in many European countries. For example, in Germany, no state has resources available for providing public services that are less than 92 percent or more than 110 percent of the national per capita average. The United States system, on the other hand, has generally preferred the market to allocate across states and has considered diversity as an inherent strength in our system. If the United States desires to change its system and move toward equality, then it should do so across-the-board so that the net effect of all federal spending and taxes moves toward equality. To single out state and local tax deductibility as the only redistributive component of federal policy is inconsistent with the long-held United States values of market reliance and diversity.

Whether or not curtailment of deductibility is good public policy should not be evaluated on regional grounds. Such a debate distorts the real public policy issues of fairness, efficiency, equity, and federalism.

Fairness

Assuming that the goal of tax reform is to broaden the tax base, then the logical starting point is the list of tax expenditures associated with the individual income tax. The major categories are:

Tax Expenditures	Revenue Loss Fiscal Year 1986 Billions of Dollars
Deductions	98.1
Pension and Retirement Contributions	70.2
Employer-Paid Benefits (except pensions)	27.2
Special Treatment of Capital Gains	26.9
Untaxed Government Benefits	25.4
Business Taxes on Individual Returns	14.2
Other	16.7
Total	292.9

The estimated federal government revenue loss for fiscal 1986 for all the tax expenditures listed above is estimated to total $292.9 billion. Any serious attempt at tax reform must look at all of these items. Most represent distortions to free markets and thus have a negative impact on long-run economic growth.

Deductibility of state and local taxes represents $33.2 billion, or only 11 percent of this total. The revenue gain from the Treasury II modification of all tax expenditures that reduce marginal tax rates would total only $49.4 billion. Thus, state and local deductibility represents 67 percent of the tax expenditure modification, but only 11 percent of the current total. Mr. Chairman, the Governors are willing to contribute to tax reform. They are not special pleaders and are prepared to do their part. However, a plan which asks state and local government — the partners in the federal system — to bear 67 percent of the burden while continuing more than $243 billion in special exemptions and deductions is not true "tax reform."

Efficiency

The Administration's tax plan, as well as the other several prominent alternatives, are all slightly less complex and perhaps slightly more equitable than the current system. However, a major benefit of tax reform should be one of increased efficiency. Tax reform should stimulate the incentives to work, save and invest by both reducing marginal tax rates and eliminating market distortions. Over the long run, this will stimulate economic growth.

The reduction of the high marginal tax rates from 50 percent to 35 percent will clearly provide incentives for economic growth. However, the failure to limit other deductions which clearly represent market distortions represents a major lost opportunity. For example, the continued allowance of a major deduction for interest payments other than mortgages continues to bias our system toward consumption as opposed to savings. Similarly, the failure to cap fringe benefits causes substantial market distortions; for example, the failure to seriously tax employer-paid health benefits contributes toward high inflation in health care costs, which in turn costs the federal government more in Medicaid and Medicare. The continuation of these imperfections in the tax system makes our economy less efficient and less competitive with other countries.

Deductibility does cause state and local spending to be somewhat higher than it otherwise would be; but given the structure of state and local taxes, there is practically no distortion of economic activity by this deduction. One may buy a house or pursue a tax shelter to minimize federal taxes, but no one pays more state and local taxes because of deductibility. In fact, I would go one step further and argue that, as many public surveys indicate, taxpayers believe that there is considerable more efficiency in government spending at the state and local level as opposed to the federal level. Thus, the elimination of deductibility is essentially a long-run shift in revenues and thus spending from state and local government which is more efficient to the federal government, which is less efficient.

Equity

For Governors, a major issue is equity. Under Treasury II, only 7 percent benefit from the capital gains exclusion. Only four-tenths of 1 percent use the foreign tax credit, and fewer than 1 percent benefit from the proposal for intangible drilling cost and the percentage depletion allowance. By contrast, the state and local tax deduction is used by more people than any other deduction in the federal code -- more than that for charitable contributions, or for medical expenses or for home mortgage interest. In Alaska, 39 percent use this deduction; in Utah, 58 percent; and in Virginia, 41 percent.

The beneficiaries of deductibility are not a privileged class. According to Treasury data, 41 percent of tax filers itemize for state and local taxes. About 51 percent of those who itemize for state and local taxes report income of less than $30,000, and only 13 percent have income above $50,000. This is primarily a deduction for middle America -- for those families where both husband and wife work, who own a home, and who pay most of the federal, state, and local tax burden. State and local tax deductibility is one of their few deductions; few have capital gains, real estate shelters, or special oil and gas tax preferences.

In examining IRAs, which are expanded under the Administration's proposal (and available to non-itemizers as well), 21 percent of IRA beneficiaries make over $50,000 or 61 percent greater than state and local itemizers in the same income tax bracket. Perhaps nowhere in the proposal is the difference between state and local tax deductibility and other tax deductions so clear as in the case of charitable contributions. IRS tables show that filers with income above $50,000 and contribute more than $3,000 receive 51 percent of the benefits. This compares with less than 32 percent benefit to the same class of persons for state and local tax deductibility.

Federalism

The deduction for state and local taxes is the oldest deduction in the federal tax system. It originally was allowed in a national income tax in 1864 and then later incorporated into the federal code when it was formalized in the individual income tax in 1913. The rationale was not to levy a tax on a tax and to provide a more precise measure of the ability to pay. Not only are these arguments still valid today, but more importantly, this deduction has been either implicitly or explicitly woven into every fiscal decision made by state and local government over the last 75 years.

The elimination of tax deductibility will clearly erode the ability of state governments to fund their increasing needs over the next decade. State and local governments will face significant demands for additional investment in the programs for which they are currently responsible. Such demands include responses to needs which were deferred during the early part of the decade, improvements in the quality of current services, growing populations in need of service, and a substantial investment in the infrastructure. By 1990, the increased annual expenditures needed to fully address these demands would include:

- $13.6 billion to fund an expanding demand for health care, particularly for the increasing aged population;
- $3.4 billion for improved correctional services, prison modernization and the reduction of prison overcrowding;
- $15.4 billion for services to a larger school-aged population and improved elementary and secondary education;
- $16.4 billion for restoring and maintaining the federal, state and local highway system;
- $2.1 billion for clean-up and maintenance of hazardous waste sites;
- $4.7 billion for waste water treatment; and
- $8.5 billion for water supply facilities.

Not only are the needs of state and local government increasing, but most expenditures for these levels of government are investments in human and infrastructure capital. Overall, over 38 percent of state and local spending is on education, and 12 percent on infrastructure -- roads, highways, parks, etc. The curtailment of these expenditures will have substantial long-run negative impacts on economic growth.

State and local government has already paid a heavy price in terms of lost federal aid as grants will have been reduced by 40 percent in real terms over the last 6 years. Governors believe they have absorbed a large share of the deficit reduction. They now believe that they are being asked to pay the price of tax reform by restricting their ability to raise revenues to meet both emerging needs and to offset some of the huge federal reductions in domestic programs. States cannot assume more responsibility, receive less money from the federal government, and be restricted in their ability to raise revenues.

The Long-run and Short-run Impacts of Ending Deductibility

In the short run, states whose state income taxes are linked to federal adjusted gross income will all witness small increases in state revenues. Some of these gains, however, will be offset by reductions in states where taxes are linked directly to federal tax liability. Over the long run, however, the impact will clearly limit state revenue-raising capability and spending. This change will not happen overnight, but legislatures and voters will be more reluctant to raise taxes. The effect is likely to be slower growth in absolute dollars in state and local spending. The estimates of this impact range between 1 percent to 20 percent. Our own sense is that after all adjustments, state and local spending will be 10 percent to 15 percent lower than otherwise would be the case.

Should we worry about this effect at all? Speaking personally, I am not sure that I would care that much if, over time, our nation decided to spend a little more on personal consumption and a little less on government consumption. In Virginia we would still strive for high-quality education, would still maintain roads necessary to get products to market, and exercise of compassion for our needy. Our public officials can sell those things in competition with bigger houses, faster cars, and vacations in Europe on a level playing field.

But it is tougher when the field is not level. That is why Governors care about balance in the tax reform package. If the bigger house and the faster car are financed with tax-deductible interest, while the schools are financed with tax payments to cover governmental interest payments that are not deductible, the playing field is not level. If the European vacation is a deductible business expense and the safety net is an after-tax cost to taxpayers, the playing field is not level.

Ending deductibility will also probably accelerate some tax changes already being made in state and local taxation. State tax drafters know that deductibility reduces the bite of state income taxes on higher bracket taxpayers. With deductibility gone, there will be a tendency to reduce the progressivity of state income taxes. This will come at a time when many states are reducing their top bracket rates because of increasing evidence that economic development may be as sensitive to them as it is to the tax burden on corporations.

The Acceptability of Alternative Modifications in the Federal Tax Treatment of State and Local Taxes

It makes little sense to end the deductibility of one or two of the big three taxes (sales, income and property) while leaving the deductibility of others. The static revenue increase assumptions used to gauge the effects are inaccurate. For example, if sales taxes are no longer deductible and the other taxes are, states will adjust. They may not eliminate sales taxes, but there will be adjustments. Oregon voters, for example, would not accept the sales tax on which they will soon be voting. Kansas officials will take less interest in relieving local property taxes through state sales tax revenues and more interest in broadening sales tax exemptions. With such major effects on taxpayers, we would find a way to rely more on deductible taxes — eroding federal revenues and distorting our tax systems as a result.

Another poor idea is to put a cap on the deduction of state and local taxes with the cap being either an absolute dollar amount or a percentage of adjusted gross income. The absolute dollar cap is good only for raising the taxes of high-income persons. That can be done directly in dealing with the rate schedule and tax breaks which are the province of those with high incomes. The adjusted gross income cap is primarily a penalty for states with the most progressive income tax systems and their taxpayers.

A much more constructive approach — in the context of broader tax reform — is your suggestion, Mr. Chairman, of maintaining the deduction for total state and local taxes above 1 percent of adjusted gross income. Such an approach minimizes the differential impacts across states and does not substantially limit our revenue-raising ability over time. Another alternative would be to maintain all current deductions but only allow individuals to take a given share (i.e., 90 percent) of the total as a final deduction. While such an approach may not be less complex, it is truly more fair.

Conclusion

In conclusion, Mr. Chairman, the Governors support meaningful tax reform that follows the general guideline of broadening the base and reducing marginal tax rates. They are willing to consider some modification of state and local tax deductibility as part of a comprehensive tax reform plan, but the total elimination of deductibility is inconsistent with the Governors' policy position. An alternative which appears to be consistent with NGA policy, Mr. Chairman, is your suggestion that deductibility be limited to that which is over 1 percent of adjusted gross income.

The states are a central part of the federal system and are prepared to make a substantial contribution to deficit reduction and tax reform. Tax reform, like deficit reduction, will slip beyond the reach of the Congress unless all parties put something on the table and unite behind one plan. The states are prepared to do their share. Governors are not special pleaders but partners in the federal system. They cannot shoulder the full burden but look forward to working with you and the Subcommittee in helping to put our federal financial house in order.

Mr. Chairman, I would be pleased to answer any questions.

Senator DURENBERGER. Our next witness is a distinguished colleague of ours, Congressman Cecil Heftel of Hawaii. He has been in office since 1976. I am particularly pleased to report that he has introduced a companion bill to my bill, S. 315, in the House of Representatives, which sets a floor of 1 percent adjusted gross income to the deduction of State and local taxes.

Congressman, thank you very much for joining us today. I hear your beeper just went off.

Mr. HEFTEL. It won't quit. Let's hear what happens if I miss this one, too.

Senator DURENBERGER. If you find it convenient to leave now we will welcome you back.

Mr. HEFTEL. Unfortunately, I will have to make that vote, but I think I will present my observations and hurry to leave.

Senator DURENBERGER. Fine.

TESTIMONY OF HON. CECIL HEFTEL, A REPRESENTATIVE IN THE U.S. CONGRESS FROM THE STATE OF HAWAII

Representative HEFTEL. I first and foremost want to congratulate you on your leadership in introducing the legislation in the Senate, the companion to which I introduced in the House, H.R. 2825.

The main points that I would like to share with the chairman and the committee is that fairness is what the administration is talking about. Fairness is what the administration says should be our principal concern.

Well, they are probably correct. It is precisely for that reason that the administration position on State and local taxes is unacceptable. In fact, it is devisive. The point is that States have different needs at different times. For the course of our Nation's history, some States have been wealthier than others. Their taxes have been sent to Washington to be shipped out to build highways in Alabama, dams in Tennessee, public housing in Louisiana, naval bases in Hawaii.

In other words, we have helped each other. It has been part of the web which holds our Nation together. Once upon a time, Texas was a relatively poor State. Now it enjoys the wealth of its great natural resources and the benefits of an economic boom.

Another point of interest is the study by the respected Advisory Commission on Intergovernmental Relations, stating that only 5 of the 10 states currently with the highest per capita tax burden were on the list 15 years ago.

New Jersey, for example, used to have much lower taxes, but a number of changes, including the discovery of industrial pollution, run amok, forced it to raise taxes high enough to join the list. The administration claims that only the wealthy benefit from deductibility because only the wealthy itemize. The administration claims that two-thirds of all taxpayers do not do so, but this figure is very misleading. It includes part-time workers, teenagers, and others who join the work force only temporarily.

If you look at who itemizes among what you can assume to be our regular full-time working force, the picture is very different. Among people with adjusted gross incomes of $10,000 or more, 53 percent itemize. Of those with adjusted gross incomes of $20,000 or more, the number jumps to 72 percent.

So by no stretch of the imagination can these people be called a minority or an exception to the norm.

And so in conclusion, I would like to simply state that it makes sense to use a 1 percent base; to use a sense of compromise, and to ignore the rhetoric that has been used to, I think, distort.

Again, I thank the chairman for his leadership, and I hope that both our body and your body will see fit to modify the final proposal so that it doesn't put an inordinate burden on the cities and States, which I think would be grossly unfair. I would be happy to answer one or two questions in 10 or 20 seconds.

Senator DURENBERGER. You have to go to a vote?

Representative HEFTEL. To a vote.

Senator DURENBERGER. Thank you very much.

Representative HEFTEL. I am delighted. Thank you very much.

Senator DURENBERGER. I won't delay you with questions. Thank you very much for coming over and for your patience with the committee.

[Congressman Heftel's prepared statement follows:]

Statement of Congressman Cecil Heftel

Mr. Chairman, thank you for the opportunity to testify on this matter of great importance to the relationship between state and local government.

As part of its tax reform plan, the Reagan administration wants to do away with the entire deduction people are currently able to take on their federal tax returns for state and local taxes. The deduction is unfair, the administration claims, because states which have low tax rates are subsidizing the states with high tax rates. In other words, the people from high tax states get to deduct more than people from low tax states.

If the 15 states with higher than average taxes want to engage in wild extravagance, the administration suggests, then they should do it with their own money and not through subsidies from more sensible states.

Fairness after all, the administration says, should be the principal concern and guiding light of tax reform. They are quite right about that. Fairness should be the standard for reform. And it is precisely on this basis of fairness, that the administration position on state and local taxes is unacceptable.

It is also divisive. The administration's argument sets one state against another, suggesting that we are not one nation indivisible but a group of independent states owing each other very little in the way of economic support. Such an attitude is downright unsettling for a state like ours sitting more than two thousand miles off the coast of California.

The point is that states have different needs at different times. Over the course of our nation's history, some states have been wealthier than others. Their taxes have been sent to

Washington to be shipped out to build highways in Alaska, dams in Tennessee, public housing in Louisiana and naval bases in Hawaii. In other words we have helped each other. Because we are one nation not a group of freebooters, the movement of revenue from one area to another is not a loss. It is part of the web which holds us together.

The administration is right that high tax states like New York and Michigan enjoy larger federal deductions for their state and local taxes than many other states. But it is worth remembering in the name of fairness, that those states have also for decades been sending more revenue to Washington than they got back in federal spending. From this point of view it can be argued that they more than pay for the benefit they get from deductibility.

It is also worth remembering that the economic health of individual states does not remain the same for ever and that many of those who don't need help now, needed it in the past and may need it in the future.

Once upon a time, Texas was a relatively poor state. Now it enjoys the wealth of its great natural resources and the economic boom that followed federal spending on defense and a whole range of other programs. These days its federal taxes are funding development in other areas.

According to a study by the respected Advisory Commission on Intergovernmental Relations, only five of the ten states currently with the highest per capita tax burden were on the list 15 years ago. New Jersey, for example, used to have much lower taxes but a number of changes, including the discovery of industrial pollution run amok, forced it to raise taxes high enough to join the list. It is very shortsighted to pit one state against another. It is also shortsighted to pit one class against another, as the administration is doing, by suggesting that the working and middle classes are subsidizing the rich.

The administration claims that only the wealthy benefit from deductibility because only the wealthy itemize their deductions. It is, however, simply untrue that only the wealthy itemize.

The administration claims that two-thirds of all taxpayers do not do so, but this figure is very misleading because it includes part-time workers, teenagers and others who join the workforce only temporarily.

If you look at who itemizes among what we can assume to be regular full-time workers, the picture is very different.

Among people with adjusted gross incomes of $10,000 or more, 53% itemize. Of those with adjusted gross incomes of $20,000 or more, the number leaps to 72%. By no stretch of the imagination can these people be called a minority or an exception to the norm.

Most important, perhaps, this plan would undermine the new federalism which the administration has so vigorously espoused. If more responsibility is being returned to the states to provide for those who need services, then the administration cannot at the same time cut back on the power of those states to pay for these services.

The administration cannot have it both ways.

The residents of Hawaii itemize at higher rates than many other states. We also have one of the highest levels of state and local taxes. As a result we have more than a passing interest in this matter.

But like most Americans we also want tax reform and know that the revenue to pay for lower tax rates must come from somewhere.

Therefore, I have introduced a bill, HR. 2825, which sets a one percent floor for state and local tax deductions. It is a companion bill to your legislation, S.315, which will permit individuals to deduct that part of their state and local taxes which exceeds one percent of their adjusted gross income.

It is a compromise which allows the federal government to collect more revenue, almost $14 billion more than they are collecting now, according to figures collected by the Senate Subcommittee on Intergovernmental Relations. It also allows state governments a measure of freedom in deciding what taxes they need to levy.

And because it is a floor that applies to the taxpayers of all 50 states, it is evenhanded in its effect. In other words, it evens out the base for everyone.

Best of all, it does not set one state or one class of Americans against another.

Senator **Durenberger**. Our next witness is Ronald Pearlman, Assistant Secretary of the Treasury for Tax Policy. Mr. Pearlman is responsible for the formulation and execution of the U.S. domestic and international tax policies. We welcome you here today. That is a good line. Are you the only one responsible?

Mr. **Pearlman**. That is interesting.

Senator **Durenberger**. You are today. Today you are the person that is responsible for formulation and execution. We welcome you here to discuss with us the President's proposal to eliminate State and local tax deductibility. I appreciate the fact that you came.

TESTIMONY OF RONALD PEARLMAN, ASSISTANT SECRETARY, U.S. DEPARTMENT OF THE TREASURY

Mr. **Pearlman**. Thank you, Mr. Chairman. Could I take credit for some tax policies and not others?

Senator **Durenberger**. We both do that.

Mr. **Pearlman**. I will take credit for the rate reductions and give the blame to someone else for the others.

I am appreciative of being here today, Mr. Chairman, not only for the purpose of presenting the administration's views on deductibility of State and local taxes, but also because I think that the subcommittee's hearing is important in the context of a full, fair discussion of fundamental tax reform. It is an important issue. It is obviously a controversial issue, and it does need the kind of public debate that it is receiving during these hearings. We are happy to participate in that debate.

As I know you know, the President's tax reform proposal does propose repeal of the current deduction afforded to itemizers for State and local taxes, other than those incurred in carrying on a trade or business or other income-producing activity.

With respect to those taxes, that is, ones incurred in connection with a business, they would continue to be deductible under the President's proposal, subject only to what we refer to as the 1-percent floor on business expenses. We think the proposed repeal, Mr. Chairman, is supported by each of the stated objectives of the President's proposals, namely, fairness, growth, and simplicity. But we think that the current deduction is unfair because it skews the distribution of Federal tax burdens as between high- and low-tax States and localities, and between itemizing and nonitemizing taxpayers.

Equally important, as I know you are aware, as the tax revenues currently lost to the deduction must be recaptured if rates are to be lowered in any meaningful way. Our ability to improve incentives for growth and to simplify the system is ultimately dependent, to a large part, on the lowering of the current unnecessarily high rates.

The fairness issue is obviously a very controversial one. I think that it is a fundamental issue in analyzing the appropriateness of the deductibility for State and local taxes, and that the critical fact in considering whether the deductibility is fair is in the context of the Federal tax system, and the recognition that the allowance of the deductibility of State and local taxes means that the Federal tax system cedes to State and local governments the ability to control, in part, the determination of the Federal tax base.

Because of the deduction, each State and local government is able, through its own tax policies, to affect, in a very significant manner, the share of Federal income taxes paid by its residents. Since State and localities vary significantly in the type of services that they choose to finance through State and local taxes, the effect of this deduction is to shift the burden of Federal income taxes from high-tax states and within a State from high tax localities to low-tax states and localities.

I would like to emphasize, Mr. Chairman, because I don't think the aspect of defining the Federal tax base has received as much of the attention. People tend to focus on the fairness between high taxes and low taxes in a State and saying, "Isn't what this proposal doing is trying to pit high-tax States against low-tax States or high-tax localities against low-tax localities?" and that is not the extent of the tax program.

It is a Federal tax program, and if we are going to try to bring a degree of fairness to a Federal tax system, even among taxpayers with more or less economic incomes, then we can't cede to State and local governments the ability to define that Federal tax base. It is for that reason that we believe that the disallowance of the deductibility of State and local taxes is essential to bring fairness to the system.

The benefit of State and local tax deductions to individual taxpayers also depends on whether or not taxpayers itemize deductions. Repeal of the State and local tax deduction would not affect those taxpayers who do not itemize deductions, and conversely, does give a benefit to those people who do itemize.

I think it is as equally important to look at not only the percentage of taxpayers who currently itemize or who don't itemize, but to look at taxpayers at the same economic income who, because of the particular circumstance they are in, whether they own a home or whether they don't own a home, itemize or don't itemize in that situation, is probably more than when we talk about aggregate statistics.

We can really see the difference in consequence between the taxpayer who bears the level of, say, State income tax, that does not itemize, and the taxpayer with exactly the same amount of income who, for other reasons, has additional deductions that puts that taxpayer in a position to itemize, gets the benefit of the deduction of the State and local tax.

I don't want to dwell on the need to reduce marginal tax rates, but I think—and I know you are sensitive, Mr. Chairman, and members of the subcommittee—that the simple fact is that lower tax rates are fundamental. It is key to this process of basic tax reform, that lower tax rates will, in and of themselves, reduce much of the significance that we know of today in decisionmaking. It is the significance of tax considerations in terms of both business and individual decisionmaking.

I have, in my written statement, addressed a couple of issues that seem to be getting a fair amount of use in terms of criticizing the proposal to disallow the deduction of the so-called tax on a tax argument or double tax argument, and the argument that it is unfair to allow a credit for foreign taxes on the one hand and proposed repeal of State and local taxes on the other. I will be happy to focus on those if you wish, but I am going to jump over them so I can complete my prepared statement.

Many of those who have argued for a retention of the deduction contend that it would make it more difficult for States and localities to raise additional revenue. In fact, however, only one-fifth of total State and local spending is financed by taxes that are taken as an itemized deduction under current law.

Moreover, assuming the current 7 percent annual growth rate in State and local spending, assuming that continues, then recent estimates indicate that the repeal of the deduction would not reduce the level of State and local spending, but would merely slow its rate of growth, and, in fact, slow it in a rather minor way. For example, the National League of Cities study recently found that total State and local spending is about 2 percent higher because of the existence of the deduction of State and local taxes.

Again, a study that Senator Chiles referred to, the Congressional Research Service study, predicted that total State and local expenditures would be only about 1.5 percent lower if the deduction were appealed. Both of these studies assume, incidently, that the nonitemizers exert no control over State and local tax decisions. We think that is probably inaccurate, and that if, in fact, those studies had considered the impact that nonitemizers, that voters have in the local decisionmaking process, that these estimates of the impact of the deductibility of State and local taxes, which in and of themselves are fairly small, would be even smaller.

In summary, Mr. Chairman, the repeal of the deduction for State and local taxes is an essential element of the President's proposal for fundamental reform. Those proposals include offsetting reductions in marginal rates and many other changes. It is a package; it is easy to pull out a piece of the package and either support it or oppose it. But it is essential to look at the package in its entirety.

There has been lots of talk about who will win and who will lose on the repeal of deductibility. We prefer to refer to the overall statistical analysis and keep in mind that if the proposals are adopted as presented, that 79 percent of the taxpayers in this country would pay either the same or a lesser amount of tax than they do under current law, and that all taxpayers will benefit from a fair, simpler system that encourages growth.

That concludes my prepared remarks, Mr. Chairman. I will be happy to try to entertain your questions.

Senator **Durenberger**. Let me start out with a comment that I think is the allegation of the Congressman. He said that at the $20,000 a year income and higher level, about 75 or 79 percent of the people itemize.

Is that correct?

Mr. **Pearlman**. I am not sure that I can give you that statistic. Give me just a minute.

Obviously, in the higher income categories, the statistic is higher than that. I have got some statistics with me on the returns, but it is not done in a cumulative way. Let me see if I can respond to that, because I don't have cumulative data with me.

Senator **Durenberger**. On the issue that you passed up in your prepared testimony, we touched on that one a little earlier, which was the issue of the fairness of a tax on tax. Rather than thinking of it as a tax on a tax, I think in terms of how you might want to reform the tax system. Income tax is the first thing. In trying to define income, I would take away from my definition of income the expenses of earning the income. I think that is a commonly accepted way to approach taxation.

This suggests to me that at least a tax on that income, in whatever jurisdiction it is earned, then, can be compared with a cost of earning that income. That doesn't include sales and property and so forth, but is there anything to that theory.

Mr. **Pearlman**. Sure. I think there is something to that. In fact, as you pointed out during your dialog with Governor Robb, we do make a distinction between income taxes and other taxes imposed on businesses, on whether they be corporate or individual businesses, and individual taxpayers.

I think that the definition of income, however, in any jurisdiction in which you have multiple taxing authorities has to pull out taxes and treat them differently. In other words, I think it is, and indeed, as I think we concluded, the statistics and the testimony states, conclude that most States do not allow a deduction for Federal tax liability. I think that is based on essentially the same theory, that if a taxing jurisdiction is going to define its own tax base and not cede the authority to adjusting that tax base to another taxing jurisdiction, both of which tax the same amount of income, then I think you have to exclude that from your general definition, which I think otherwise I completely agree with, the idea that repealing deductibility is taxing some other jurisdiction's tax.

Senator **Durenberger**. Let me ask you to enlighten us on something that we in this committee call tax room. I referred to it earlier. One of the early theories of the New Federalism of the administration was that we were going to defer the Federal tax and make room for the States to enact their own taxes. I implied in my earlier question that we have done just the opposite—unless you want to discuss rate reduction as tax room—and I guess that is where I am asking the question. Instead, the National Government has gone further into excise taxes, which is the easiest way for States to raise money, raise them, lower them, raise them, lower them. We have gone even heavier in that area.

Tell me, where have I missed here? How have we benefited the State and local government in terms of their ability to enact new taxes or increase existing taxes?

Mr. **Pearlman**. Well, I think you are probably right. I don't think we should treat lightly the benefit to State and local governments from improvements in the Federal tax system. Indeed, for example, with the number of States that now currently piggyback on the Federal system, efforts over the last few years and this effort, the President's effort to broaden the Federal tax base to try to bring within the definition of income a broader category of transactions that are currently enjoyed, repealing various preferences are going to have a material beneficial effect on States.

Indeed, I would presume, although I don't want this to sound—I am saying it because I assume it is going to be the case, that in many States, their income tax base is going to be broadened significantly because of the base broadenings in this proposal. That will probably give at least some States the ability, maybe many, many States, to go to lower tax rates or at least if not lower, to have a source of revenue that they would not otherwise have.

We share your view about tax room. Our view on excise taxes is really the thing that we think is not a place where the Federal Government should seek revenues except where absolutely necessary. We, in our original Treasury proposals, when we analyzed the value-added tax, one form of which could be a national sales tax, one of the concerns we expressed in our written analysis of the value-added tax as a fundamental reform option was the potential intrusion on a traditional tax source of State and local governments.

I think we would share your view that we do have to be careful that we are not intruding in areas where State and local governments have traditionally taxed. I would submit, however, that fundamental income tax reform is going to be beneficial to States, and I am talking now about growth. I think if, indeed, we have a tax package that promotes growth in this country, that is going to benefit States, but that is not what I am talking about. I am just talking about the simple fact that if we have a tax system that has a broader tax base, then most states which now base both their corporate and their individual income taxes on that tax base are going to benefit in a dramatic way, and I would also predict that States would move with much more enthusiasm to using a Federal tax base if we can go down the road of trying to make that base a broader base.

Senator **Durenberger**. OK. Let's assume you are right about that, and we are at least making a little bit of room. What are your general views on tax capacity and fiscal disparities among the States? I know the President, for a long time, has had the view that there are no disparities, and your testimony says that that we need to eliminate deductibility, because doing that will even out the rates in the Federal tax system.

But I see that as being part of the problem, since in a Federal tax system, as opposed to a national tax system, if I can make that distinction, what a taxpayer pays is a function of his total tax worth. And what deductibility does, then, is to reduce the disparities between what a taxpayer would pay regardless of whether he lived in Wyoming or New York.

As an example, I am told that the difference in the highest marginal tax rates between New York and New Jersey, which is now about 7 percent, without deductibility, would jump to 14 percent.

If that is true, the problem is not just that we have created a little tax room for New York; it is that we have also created a large disparity between the tax burden or total tax burden of a person who lived right next door in New Jersey.

What are your views on that?

Mr. **Pearlman**. I think that what you describe is correct. I think that there is no question that to the extent that you allow a Federal tax deduction, and thereby pass from the individual taxpayers' State tax return to his Federal return a share of that cost, that at least with respect to the perception of that individual taxpayer, he might view himself as more closely aligned, if you will, in terms of overall tax burden with his neighbor.

In fact, what we found, though, is that tax burdens around the country are dramatically different. We have analyzed individual tax burdens, and they do vary from very high-tax States to States that have very low taxes, and I think the Federal tax deduction does eliminate some of that disparity.

But the price you pay for eliminating that disparity, I would submit, is creating a Federal tax system that taxes people very unevenly, depending on where they live and what their State and local tax burdens. I think people are concerned about fairness in the Federal tax system. I don't think they think in terms of an overall tax system and what their combined rate is. I think they are concerned about a taxpayer in one part of the country paying a rate that is materially different than another part of the country.

We know, and I would presume that most people would agree, that State and local tax policies may well be influenced by the desire to provide a greater degree of services in one jurisdiction versus another. I recognize that that is not the only reason that tax burdens differ, but it is certainly a part of the reason.

At least from a Federal tax system, I think that my judgment is that is a price too high to pay.

Senator **Durenberger**. When we had a chance to visit with the Secretary when he came before the Finance Committee, I recall making the observation that there was sort of implicit in this level playing field the notion that the whole country ought to be a Wyoming or something like that, and I caught heck from some of my colleagues. But that thought occurred to me.

I sent somebody out to check and give me a little figure. The reality is that there are more undocumented workers in New York City than there are people in Wyoming. That has something to do with the difference in the tax rates. I mean, New York isn't deliberately profligate up there, or whatever the appropriate word is. That has something to do with the difference between the New Yorks and the Wyomings. I suppose if you and I had a chance to come at this whole issue of the Nation and what is good for it from the spending side or the budget side rather than tax side, we might be looking at the efficiencies in the way the Federal Government can help support services for undocumented workers or among refugees or acid rain or something like that, and we would probably find that this is the least efficient way to do it, if efficiency was our own goal. We would start with general revenue sharing, which is pretty efficient, if it is targeted. Then we go to categorical grants and then IDB's, which are only slightly less inefficient than this. But if you and I had the chance to say, if we are going to spend *x* number of dollars out of your Federal pocket as opposed to something else to help out your State and local pocket, we probably would be someplace else other than deductibility looking for that, wouldn't we?

Mr. **Pearlman**. I think we would.

Senator **Durenberger**. On the efficiency argument, I can't make a very good efficiency argument for deductibility. I wouldn't.

Mr. **Pearlman**. Could I offer just a slight variation on the efficiency argument? I think we would be someplace else, because the Federal tax deduction is not very efficient. By definition, it is not.

But in addition, I would suggest that not only is it inefficient just in terms of the tax rate, the fact that you pay a lot more in order to get that dollar of tax revenue to State and local government, but it also reflects no articulation of Federal policy in terms of what you are paying for, what those expenditures are going for.

Presumably, we would all share the view that there is certain basic social functions, police functions, so forth, that should be provided by the State and local level, and Federal tax revenues may be an appropriate way to raise those revenues.

At some point, we might not share the same view as the local services that are increasingly being provided by State and local government that one might argue are not traditional kinds of services and yet which the Federal Government, at least indirectly, subsidizes, if you will, through the Federal tax deduction. So I would suggest it is a combination of the inefficiency of the tax cuts, in which we see not only with respect to State and local tax deduction, we see it with any preference in the tax system, but in addition to that, no articulation of Federal policy as to what that incentive should be used to finance.

Senator **Durenberger**. Lawton?

Senator **Chiles**. Thank you, Mr. Chairman. I think that the efficiency argument would be more valid if we were trying to figure a way, or if we were saying we were going to determine a way as to how we were going to effectively transfer $34 or $50 billion, whatever the number would be, from the Federal Government to the States.

But we aren't doing that now. We are deciding how much money we can take away from the States. So I don't think the efficiency argument right now, when you see that we are not talking about transferring money to States, we are talking about how much we are going to take away, and how much we have been taking away since 1981. I have been a participant. I have been at the table with a scalpel, and we are there now taking away some more. So I don't know how the hell we talk about efficiency, whether this is efficient or not.

It is a question of it is inefficient to take away some more money, because that is, in effect, what we are talking about doing.

One of the concerns that I have about it is that when I look at the numbers, and I look at tax expenditures and know that it is roughly a $400 billion a year is what we are talking about, it is an area that is growing at roughly 10 percent a year, $4 billion a year. I am told, in my mind, that this is our problem, that we have got this tremendous growth of tax expenditures, and so we are going to have a tax reform bill, and we are going to do something about that.

I am also told a tremendous amount of these tax expenditures occurred since the 1970's. That has been the explosion of the growth and the continuation. I am looking at something that started in 1913? You know, is this one of those dirty loopholes that has been going out there? It has been there since 1913; it has been in the open; everybody has sort of seen it happen over that period of time. It doesn't seem to fall into the category of some of these other tax expenditures that I see, and yet, I see we are coming down and we are going to swoop down and we are going to wipe this one out.

Part of the wipeout, it looks like to me, it leaves room to not do a job on a number of these other tax expenditures that, if this one isn't in there, you are going to have to go back and look over the list; you are going to have to go back and determine how Treasury II grew from Treasury I and what were the reasons? How political are they? How much were economic and how much were political reasons that changed, if you don't have this sort of block of revenue?

Those are things that I am certainly going to be weighing just in my decision, and any light you can shed on that question, I would be glad to have.

Mr. PEARLMAN. Senator, let me make two comments. First, I would again refer, in connection with the comments you made on efficiency, to the analyses that have been done today, and I am sure there will be more. But the data, at least to date, does not indicate—I think there is consensus that tax deductions are not the most efficient way for the Federal Government to spend money.

But once you get beyond that, the data does not indicate the disastrous effect on State and local governments' ability to appropriate funds for necessary expenditures that has been suggested in terms of statements in the media; that if, in fact, there is a—let's use the two numbers that the National League of Cities and the Congressional Research studies use.

If there is a 1.5- to 2-percent reduction in the rate of growth of State and local expenditures overall, and obviously, those numbers are going to change from State to State and from locality to locality and from tax to tax. But if overall, we assume that is the case, I think it is probably an overstatement to say that that would produce a disaster in terms of State and local governments' ability to finance their current needs.

With respect to the——

Senator CHILES. But you do recognize, though, that it is another cumulative feature in the features we have had. If we have already cut off an arm and we have cut off a foot and all we are going to do now is take off three more toes on the other foot, it is something to consider whether the patient will be ambulatory or not.

Mr. PEARLMAN. I will go with that. Yes; I think that it is certainly appropriate to evaluate the impact and, indeed, I think that is the contribution of these studies. It is valuable to evaluate the impact.

Senator CHILES. Even if it is only 2 percent in the growth of States, that is 2 percent not in a vacuum. That is 2 percent that has to be accumulated and put on top of what happens when we take revenue sharing out.

What happens when we cut community development block grants? What happens when we cut or talk about abolishing UDAG and the Rural Housing Program and all of the other things that we are talking about doing?

Mr. PEARLMAN. I completely agree with you. I think the effect of a change in the deductibility of State and local taxes is quite an appropriate question to raise and to try to analyze. My only point was that I think it is unfortunate that the consequences seem to be overstated from what the studies would, at least to this point, show.

With respect to the other item you raised, and that is why this deduction is repealed and why are other so-called loopholes are left in the system, if we could talk about specific ones, but let me begin by saying that at no point, I think, have you seen anything by either Treasury or the administration and hopefully, by no spokesmen that talk about the state and local tax deduction as a loophole or a tax gimmick. We never view it that way. We never have. Very early in our review stages of fundamental tax reform, we made a judgment that is not unique to the original Treasury proposal. It has been discussed by people dealing with the Federal tax system over many, many years that in a system in which you are trying to broaden the Federal tax base, when you are trying to have an even tax base across the country, that it is appropriate not to allow the deduction for State and local taxes.

It does have other consequences like the revenues that have the benefit of rate reduction, but frankly, we didn't go around looking for a big dollar item saying, "We want to cut individual rates. Let's pick the one that produces a large amount of revenue."

Well before we started talking revenues, we made a judgment, a policy judgment that State and local tax deduction should be repealed.

We did the same thing, originally, with respect to the charitable deduction, for example, just to use another illustration. We can talk about others if you wish. When we changed that decision, and that decision was changed because the President believed that as a matter of Federal tax policy, that it would be evenly applicable across the country to every taxpayer as a matter of Federal tax policy, that we should continue our incentives for charitable giving.

One can define that as a tax expenditure in traditional terms. We did, we do. I think all one can do is go down the list of items that are currently in the Internal Revenue Code or that could be in the Internal Revenue Code and make a policy judgment about each one of those. I think they each need to be defended or their elimination justified, one on one, on the policy that applies to that particular item. I think we should be in a position, the administration should be in a position to do that on each of the decisions it made in its proposal, and I presume we will all be in a position to do that as the Congress goes forward in this debate.

Senator DURENBERGER. Carl Levin?

Senator LEVIN. Thank you, Mr. Chairman, and Mr. Pearlman.

A couple of weeks ago, before the Small Business Committee, you and I had a discussion over a letter which we had received from the Secretary of the Treasury relative to the impact in our States of the repeal of the State and local tax deduction. Senator D'Amato and, I think, others, took umbrage at that letter. I think every Member of the Senate received it, at least those Members that were from States that rely heavily upon State and local taxes, because the letter read as follows: "Dear Senator Levin, I understand you may have received information regarding the repeal of State and local tax deductions and its effect on taxpayers in your State. Such data is being circulated, and much of it is incorrect or misleading. In order that you may have accurate data, I am enclosing information that summarizes the impact of our proposals regarding this issue on your State."

Then the Secretary, in his letter, attached information in which he said summarizes the impact. He took a typical family, what he called a four-person family that itemizes deductions, and the purpose of this exercise was to show us that even with the loss of the State and local deduction, that family would be ahead. That was the purpose of his letter.

We told you at the time that the letter was misleading, because you used the one wage-earner family. We have lots of two wage-earner families in this country. We asked you to ask the Secretary of the Treasury whether or not that isn't true and would he send us a correction letter showing us the impact on the two wage-earner family.

Have you taken that request of Senator D'Amato and myself back to the Secretary of the Treasury?

Mr. PEARLMAN. Yes, we have, and let me say that I don't share your view that the letter was misleading. I will be happy to explain why, but there was no intention to provide other than full data. We think that that data that was provided is the best data to isolate the variable of the State and local tax deduction on a median income family of four which, incidentally, has been the traditional standard which has been used, whether it is right or wrong, whether it is socially different or not. It has been the traditional standard that has been used over the years in evaluating tax changes.

We have absolutely no problem in doing the same analysis with two-earner families. In fact, we are doing that now. The mechanical problem of evaluating that data, however, will be, and it is under way—and we should have that data completed fairly quickly—is that it introduces other variables. It doesn't permit you to look at the State and local tax deduction and say what effect is it going to have on a family of four. It requires that you look at the State and local tax deduction and the two-earner deduction and the child care expense deduction all together, and so it is very difficult, then, to pull out those variables.

It is for that reason that we used the single-earner family. It was not for the purpose of misleading anyone. It was for the purpose of identifying that variable. It is for that reason that I believe that the letter was not only not misleading, but did accurately identify that variable, and we stand by the statement we made that for a median income family of four around the country, the variable of State and local tax deduction will, in fact, reduce taxes dramatically for nonitemizers and significantly for itemizers.

It will not produce tax increases, but we are going to provide the two-earner data to you, Senator, as well as other members.

Senator LEVIN. You didn't provide it to us 2 weeks ago. We did decide to do it. I just happen to have it here. [Laughter.]

This is the information that the Secretary of the Treasury sent us. He took the family of four, joint return, said, again, that this table summarizes the impact—that is his word—summarizes the impact of the loss of the deduction for state and local taxes on our State. And he showed us under his assumptions and IRA's and everything else. He said, "Look, even with the loss of that, under current law, that family is paying $3,194. Under the President's proposal, that family will pay $3,002. Therefore, that family is $192 ahead."

But when you look at the two wage-earner family, lo and behold, they come out behind; same assumptions, except, of course, the two wage-earner family gets the marriage deduction.

Mr. **PEARLMAN**. Then the assumptions are not the same.

Senator **LEVIN**. They are exactly the same, because the marital deduction is in the law.

Mr. **PEARLMAN**. But——

Senator **LEVIN**. Let me finish my part before you have your turn. Is there any doubt in your mind that the two wage-earner family will come out differently than the one wage-earner family?

Mr. **PEARLMAN**. There is no doubt in my mind, but it will not be because of the deductibility of State and local taxes.

Senator **LEVIN**. But you are missing your own point.

Mr. **PEARLMAN**. I'm sorry.

Senator **LEVIN**. You are missing your own point. The Secretary of the Treasury said to us, "Don't worry about the loss of State and local tax deductions. Here is the chart," he says, "that summarizes the typical," summarizes, his word, "that summarizes the situation, which is still better off." I am talking your assumption that you are still better off. That is the argument. You are still better off in your State of Michigan, even if you lose the State and local tax deduction. I am saying that the 54 percent of married couples who itemize who are two-earner familiar families, 54 percent, in Michigan—and I don't know if that is typical. I presume it is not too far off, but 54 percent of the married couples who itemize are two-earner couples in Michigan. No one can tell me they are better off.

Mr. **PEARLMAN**. Senator, the only thing I can say to you, I will just say it again, is that if your numbers are correct—I have no reason to believe they are not—it simply can't be because of the disallowance of State and local tax deduction. It may well be because of our proposal to disallow the two-earner deduction. I don't know the extent if in all States or whether in Michigan, our proposal to allow the two-earner deduction adversely affects two-earner families, but it is not, I think, due to loss of the tax deduction allowance.

Senator **LEVIN**. It is under your whole proposal, including the loss of the State and local deduction, isn't that correct?

Mr. **PEARLMAN**. Assuming your numbers are correct, our proposal would indicate, and I will take your numbers as a given, that by $140 or so, a married couple in New York may be worse off.

Senator **LEVIN**. Michigan, Michigan.

Mr. **PEARLMAN**. Pardon me. Excuse me. But that is not what the Secretary's letter dealt with. The Secretary's letter was a response to the issue of State and local tax deduction and was done for a reason: Because Members of Congress were being told, on a variety of facts that we knew were inaccurate, that is, we could, through the tax data that the Treasury has through the computers, provide at least more accurate data. Then Members could draw their own conclusions.

Senator **LEVIN**. The purpose of the letter is clear. Mr. Pearlman, the purpose of the Secretary's letter is clear. He is saying that even with the loss of that deduction, your average family is better off with the whole package. It is not true for the two wage-earner family under your assumption. They are worse off under that package.

Mr. **Pearlman**. Senator, I do not think that is what the Secretary's letter was saying. I think what the Secretary's letter was saying is that Members of the Senate, if you are being told that the loss of the State and local tax deduction is going to cause tax increases in your States, that that is wrong, and we will stand by the data we have provided that shows that.

Now if, in fact, the loss of the two-earner deduction produces tax increases in the State of Michigan or some other State—and as I indicated, we are trying to do that data now for all 50 States—then I think that is an issue, and it needs to be evaluated, but we will stand by the statement that I think the Secretary was making in his letter, and that is the loss of the State and local tax deduction will not produce tax increases for taxpayers in the State of Michigan or any other State.

Senator **Levin**. You can keep repeating that, but you are not responding to the question, which is that the trust of the argument that the Secretary of Treasury is making is that overall, under the President's proposal, that average family is still better off. There is no other meaning to that letter and that representation; indeed, to your representation here today.

You are saying that the typical family, even with the loss of the State and local tax deduction, is better off, and what I am showing to you is that a two wage-earner family, under the President's proposal, is worse off. I am not saying it is just because of the loss of the State and local tax deduction. I am saying under the President's proposal, that two wage-earner family is worse off, and that proposal includes the loss of the State and local tax deduction.

So you are not responding to your own numbers, because your numbers, in that example, which is used by the Secretary of the Treasury and every Senator got this, at least on the so-called high taxes, this is used for one purpose alone, and that is, even with the loss of that deduction, folks, because of other aspects of this proposal, you are better off. You are better off, he told us, by $192.

I am saying that quite the opposite is true if you are a two wage-earner family. It is very clear from our analysis that that is true.

Would you agree with this?

Senator **Durenberger**. I don't think he is going to change his response, Carl.

Mr. **Pearlman**. I don't think there is anything else I can say.

Senator **Levin**. Can I ask a different question?

Senator **Durenberger**. That was enough.

Senator **Levin**. Is my time up?

Senator **Durenberger**. Do you have more questions?

Senator **Levin**. If my time is up, OK.

Senator **Durenberger**. Lawton?

Senator **Chiles**. I don't have anything else.

Senator **Durenberger**. Ron, thank you very much for being here. We appreciate it.

Before you go, can somebody dig up the figure on what percentage of the $20,000 a year and over taxpayers itemize?

Mr. **Pearlman**. Can we get it to you?

Senator **Durenberger**. Yes; and then also, I need some information on the figure of what percentage of State and local income, sales, and property taxes does that group pay. It would help to get that. And the third thing, somebody did a run for me on S. 315, which is my 1 percent proposal, against Treasury I, and it showed that the tax, the revenue loss was only something like $17.7 billion. I assume that——

Mr. **Pearlman**. From that base, from the Treasury I base.

Senator **Durenberger**. Yes, that is right. So Treasury I is reducing, plus the deductibility is reducing. If you could run S. 315 against Treasury II, I would be thankful.

Mr. **Pearlman**. Sure; be aware that that is an annual number, not a cumulative number.

Senator **Durenberger**. Right.

Mr. **Pearlman**. Let us do this. We can run that for the budget period for you. That would be the best way to give you that information, just give you annual.

Is that all right?

Senator **Durenberger**. Yes. Thanks again, very much.

[Mr. Pearlman's prepared statement and a letter to Senator Durenberger follow:]

FOR RELEASE UPON DELIVERY
EXPECTED AT 1:30 P.M. EDT
Wednesday, June 26, 1985

STATEMENT OF
RONALD A. PEARLMAN
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON INTERGOVERNMENTAL RELATIONS
OF THE SENATE GOVERNMENTAL AFFAIRS COMMITTEE

Mr. Chairman and Members of the Subcommittee:

I am pleased to appear before you today to discuss the treatment under the Federal income tax system of amounts paid for State and local taxes. As you know, current law allows taxpayers who itemize deductions to deduct their payments for State and local income, sales and real and personal property taxes without regard to whether the taxes were incurred in carrying on a trade or business or income-producing activity. In addition, although nonitemizing as well itemizing taxpayers can deduct State and local taxes (other than income taxes) incurred in carrying on a trade or business or which are attributable to property held for the production of rents and royalties, State and local taxes attributable to other income-producing property are deductible only by itemizing taxpayers.

The President's Tax Reform Proposal. Under the President's Tax Proposals to Congress for Fairness, Growth, and Simplicity, the itemized deduction for State and local income taxes and other taxes not incurred in carrying on a trade or business or income-producing activity would be repealed. State and local taxes (other than income taxes) which currently are an itemized deduction but which are incurred in carrying on an income-producing activity would be aggregated with certain other miscellaneous expenses and would be deductible above a threshold of one percent of adjusted gross income.

Repeal of the itemized deduction for State and local taxes is supported by each of the President's tax reform proposals' stated objectives of fairness, growth, and simplicity. The current deduction is unfair in that it skews the distribution of Federal income tax burdens as between high tax and low tax States and localities and as between itemizing and nonitemizing taxpayers. Equally important, the tax revenues currently lost to the deduction must be recaptured if tax rates are to be lowered significantly. Our ability to improve incentives for growth and to simplify the tax system through tax reform is ultimately dependent on lowering the current, unnecessarily high marginal tax rates.

Fairness. Analysis of the deduction for State and local taxes appropriately begins with the question of its fairness. The critical fact in considering whether a deduction for State and local taxes is fair in the context of a Federal tax system is that the level of the deduction is controlled by the individual tax policies of countless State and local governments. Because of the deduction, each of those State and local governments is able through its own tax policies to affect significantly the share of Federal income taxes paid by its residents. Since States and localities vary significantly in the type and extent of public services which they choose to finance through State and local taxes, the effect of the deduction is to shift significantly the burden of Federal income taxes from high tax States and localities to low tax States and localities.

The benefit of the State and local tax deduction to individual taxpayers also depends on whether the taxpayer itemizes deductions. Repeal of the State and local tax deduction would not directly affect the two-thirds of taxpayers, typically those with low or middle incomes, who currently do not itemize deductions. Conversely, under current law, and indeed, under any rate structure designed to achieve a given amount and distribution of Federal income taxes, nonitemizers must pay higher taxes in order for itemizing taxpayers to deduct their State and local taxes.

Need for Lower Marginal Tax Rates. Aside from the issue of fairness, the revenues at stake with respect to the State and local tax deduction are critically important to our efforts to reduce marginal tax rates. Under current law, the deduction for State and local taxes is projected to result in a revenue loss of approximately $33 billion in 1987, increasing to $40 billion by 1990. Unless those revenues are recaptured through a repeal of the State and local tax deduction, a significant reduction in marginal tax rates will not be possible within the constraint of revenue neutrality. We should not lose sight of the fact that lower tax rates are the keystone of fundamental tax reform, and that lower rates will, in and of themselves, do much to reduce the significance of tax considerations in personal and commercial decisionmaking and thus to promote fairness, growth, and simplicity.

"Tax on a Tax" Argument. Some have said that the deduction for State and local taxes should not be repealed because repeal would amount to imposing a "tax on a tax." We believe this argument is more rhetorical than real. It is contradicted by the practice of most States with respect to their own tax systems: 43 states and the District of Columbia impose a personal income tax, yet 28 of these jurisdictions do not permit a deduction for Federal income tax, and many also allow no deduction for local taxes. Similarly, of the 46 States that impose a corporate income tax, 39 do not permit a deduction for Federal income taxes.

Others have argued that repeal of the State and local tax deduction is inconsistent with the allowance of a credit for certain taxes paid to foreign governments. This asserted analogy between foreign taxes and State and local taxes is unsound. The foreign tax credit is an integral part of a system of international taxation in which primary taxing authority is generally ceded to the country where income is earned. Thus, U.S. residents are allowed a foreign tax credit for foreign taxes paid just as foreign taxpayers earning income in the U.S. are generally allowed a credit in their home country for U.S. taxes paid. In contrast to this international system in which primary taxing authority is ceded to one country, our Federal system of government necessarily involves different levels of government applying tax to the same taxpayers and the same income. The deductibility of taxes paid to overlapping domestic jurisdictions thus is not an issue of double taxation but rather of the extent to which each such jurisdiction is able to define its own tax base. As indicated above, most States assert this authority for themselves by denying a deduction for Federal income taxes.

Effect on State and Local Spending. Many of those who have argued for retention of the deduction for State and local taxes contend that repeal would make it much more difficult for States and localities to raise necessary revenue. In fact, however, only one-fifth of total State and local spending is financed by taxes that are taken as an itemized deduction under current law. Moreover, assuming the current seven percent annual growth rate in State and local spending continues, recent estimates indicate that repeal of the deduction would not reduce the level of State and local spending, but would merely slow its rate of growth. Thus, a National League of Cities study found that total State and local spending is about two percent higher because of the existence of the deduction of State and local taxes. Similarly, a study by the Congressional Research Service predicted that total State and local expenditures would be only 1.5 percent lower if the deduction were repealed. Both of these studies assume that nonitemizers exert no control over State and local spending and tax decisions; thus, they represent upper bounds on the estimated effects. Since the figures represent averages, the effect on particular States and localities could be higher or lower.

If additional Federal assistance to State and local governments is desirable, provision of that assistance through a deduction for State and local taxes is neither cost effective nor fair. On average, State and local spending increases by less than fifty cents for every dollar of revenue loss. Moreover, the deduction benefits high-income communities more than low-income communities. Finally, the deduction is not targeted to specific categories of State and local spending, but is as much a subsidy for spending on recreational facilities as for public welfare spending.

Effect on Taxpayers. Repeal of the deduction for State and local taxes is an essential element of the President's proposals for fundamental tax reform. Those proposals include offsetting reductions in marginal rates and many other changes. Much has been said and written about who will "win" and who will "lose" under the President's proposals, and in particular about the impact of repealing the State and local tax deduction. In all of this, it is well to bear in mind that if the President's proposals were adopted, 79 percent of taxpayers would pay the same amount or less tax than they do under current law, and that all will benefit from a system that is fairer and simpler and encourages growth.

This concludes my prepared remarks. I would be happy to respond to any questions that you might have at this time.

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

JUL 25 1985

Dear Senator Durenberger:

This letter provides information you requested at the June 26 hearing of the Senate Subcommittee on Intergovernmental Affairs on deductibility of State and local taxes. I would like this information to be included in the record of that hearing.

You asked for an estimate of the revenue loss from permitting itemizing taxpayers to deduct taxes paid in excess of a floor of one percent of adjusted gross income (AGI) using the President's proposal as the base line. In addition, you asked in a recent letter that we also estimate the revenue effect of maintaining full deductibility of taxes paid. Due to the lower marginal tax rates under the President's proposal, the cost of deductibility is less than under current law. The revenue losses below assume the proposal would be effective January 1, 1986.

Revenue Loss From Revising the President's Tax Reform Proposal
($billions)

Fiscal Year	Allow Deductibility in Excess of One Percent of AGI	Allow Full Deductibility
1986	-3.5	-4.1
1987	-23.1	-26.9
1988	-21.2	-24.6
1989	-22.9	-26.7
1990	-24.8	-28.9

You also asked what percentage of taxpayers earning income of $20,000 or more a year itemize deductions. Of all taxable returns with $20,000 or more of AGI, seventy-two percent itemized deductions in 1983. However, it is important to note that both the percentage of taxpayers claiming the taxes paid deduction and the value of the deduction vary according to income group. I am enclosing tables which show the breakdown of returns claiming the taxes paid deduction and the cummulative value of the deduction by income group. As shown in Table 2, although roughly 75 percent of all taxable returns have AGI of $30,000 or less, this group accounts for only 15% of the total value of all taxes paid deductions.

Finally, you asked what percentage of State and local income, sales, and property taxes are paid by itemizers earning $20,000 or more. Based on information from the 1982 Statistics of Income Individual Tax Returns and the Advisory Commission for Intergovernmental Relation's Significant Features of Fiscal Federalism, itemized deductions on 1982 taxable returns with $20,000 or more of adjusted gross income accounted for between 64-70 percent of State and local individual income tax receipts, 33-36 percent of local property taxes and 12-13 percent of State and local sales taxes. The range is estimated by comparing total itemized deductions with total fiscal year receipts for State and local governments in 1982 and 1983.

I hope this information is helpful in your considerations.

Sincerely,

Ron

Ronald A. Pearlman
Assistant Secretary
(Tax Policy)

The Honorable
David Durenberger
Chairman, Subcommittee on
Intergovernmental Relations
United States Senate
Washington, D.C. 20510

Table 1

Number and Percentage of Returns with Taxes Paid Deduction - 1983

Adjusted Gross Income Class	All Returns (thousands)	Taxable Returns (thousands)	Returns with Taxes Paid Deduction 1/ (thousands)	as percent of All Returns	as percent of Taxable Returns
Total	96,321	81,492	34,794	36.1%	42.7%
Under $ 5,000	17,836	5,806	538	3.0%	9.3%
$ 5,000 - $ 9,999	16,828	14,615	1,680	10.0%	11.5%
$ 10,000 - $ 14,999	13,878	13,523	2,621	18.9%	19.4%
$ 15,000 - $ 19,999	10,770	10,672	3,420	31.8%	32.0%
$ 20,000 - $ 24,999	8,848	8,802	4,166	47.1%	47.3%
$ 25,000 - $ 29,999	7,357	7,329	4,591	62.4%	62.6%
$ 30,000 - $ 39,999	10,421	10,389	8,140	78.1%	78.4%
$ 40,000 - $ 49,999	5,148	5,136	4,651	90.3%	90.6%
$ 50,000 - $ 74,999	3,591	3,582	3,393	94.5%	94.7%
$ 75,000 - $ 99,999	823	821	792	96.2%	96.5%
$ 100,000 - $ 199,999	622	620	607	97.6%	97.9%
$ 200,000 - $ 499,999	162	162	160	98.3%	98.5%
$ 500,000 - $ 999,999	25	25	25	98.6%	98.7%
$ 1,000,000 & over	11	11	11	98.5%	98.6%

Office of the Secretary of the Treasury
Office of Tax Analysis

July 23, 1985

1/ Taxes paid deduction net of State income tax refunds.

Note: Detail may not add to total because of rounding.

Source: Internal Revenue Service, Statistics of Income for 1983 individual income tax returns.

Table 2

Cumulative Percentages of Taxable Returns, Returns with Taxes Paid Deductions, Taxes Paid Deduction, and the Value of the Taxes Paid Deduction -- 1983

Adjusted Gross Income Class	Cumulative Percentages of:			
	Taxable Returns	Returns with Taxes Paid Deduction	Taxes Paid Deduction 1/	Value of Taxes Paid Deduction 2/
Under $ 5,000	7.12%	1.55%	.37%	**
Under $ 10,000	25.06%	6.38%	2.06%	.30%
Under $ 15,000	41.65%	13.91%	5.25%	1.43%
Under $ 20,000	54.75%	23.74%	10.45%	3.94%
Under $ 25,000	65.55%	35.71%	17.94%	8.27%
Under $ 30,000	74.54%	48.91%	28.04%	15.16%
Under $ 40,000	87.29%	72.30%	50.00%	33.17%
Under $ 50,000	93.59%	85.67%	66.00%	49.75%
Under $ 75,000	97.99%	95.42%	82.02%	70.14%
Under $ 100,000	99.00%	97.69%	87.41%	78.20%
Under $ 200,000	99.76%	99.44%	93.80%	88.93%
Under $ 500,000	99.96%	99.90%	97.18%	94.93%
Under $1,000,000	99.99%	99.97%	98.39%	97.11%
All Returns	100.00%	100.00%	100.00%	100.00%

Office of the Secretary of the Treasury July 24, 1985
Office of Tax Analysis

1/ Taxes paid deduction net of State income tax refunds.

2/ The value of the deduction for taxes equals the marginal tax rate times the lesser of the deduction for taxes (net of State income tax refunds) or total itemized deductions (net of State income tax refunds) in excess of the zero bracket amount.

** Less than .005 percent.

Note: Detail may not add to total because of rounding.

Source: Internal Revenue Service, Statistics of Income for 1983 individual income tax returns.

Senator DURENBERGER. We will now hear from a group of panellists including Speaker John Martin, Maine House of Representatives; Representative William Schreiber, Minnesota House of Representatives; County Executive Peter Shapiro from Essex County, NJ; Mayor Joseph Leafe, city of Norfolk, VA; and Ms. Marti Zins, president of the Minnesota Education Association.

We welcome you all. You have an opportunity to speak in the order you were introduced. Your full statements will be made a part of the record. Because of the growing lateness of the hour—I think we told you this ahead of time—try to limit your formal testimony to 5 minutes. Your full statements will be made a part of the record.

We will proceed with Mr. Martin.

TESTIMONY OF SPEAKER JOHN MARTIN, MAINE HOUSE OF REPRESENTATIVES, NATIONAL CONFERENCE OF STATE LEGISLATURES; REPRESENTATIVE WILLIAM SCHREIBER, MINNESOTA HOUSE OF REPRESENTATIVES, NATIONAL CONFERENCE OF STATE LEGISLATURES; PETER SHAPIRO, COUNTY EXECUTIVE, ESSEX COUNTY, NJ, NATIONAL ASSOCIATION OF COUNTIES; MAYOR JOSEPH LEAFE, CITY OF NORFOLK, VA, NATIONAL LEAGUE OF CITIES; AND MARTHA LEE (MARTI) ZINS, PRESIDENT, MINNESOTA EDUCATION ASSOCIATION

Mr. MARTIN. Thank you very much, Mr. Chairman. First of all, I want to thank you for the opportunity to appear here today on behalf of the National Conference of State Legislatures.

I am John Martin, At present I serve as the Speaker of the House of Representatives in Maine, a position I have had for 10 years, and am presently serving as the chairman of the State Federal Assembly to the National Conference of State Legislatures, for whom I am appearing today.

I would also like to inform you that I was a former IGR staff member under Senator Muskie a number of years ago, more than I care to think about.

Senator CHILES. I don't think it was very long ago.

Mr. MARTIN. Thank you. Let me respond to the issue of deductibility and the position that you have taken at this point. I would like to very briefly summarize the present policy of NCSL.

State legislatures must craft and adopt balanced budgets, and when our sessions adjourn, a delicate balance has been struck. For example, we adjourned on Thursday night.

Thus, if Federal tax changes are retroactive, our budgets will very likely be out of balance.

Second, State legislatures feel that deductibility is an essential part of the Tax Code and that it represents a key ingredient of the decision by the States in 1913 to give the Federal Government the power to establish the income tax.

Third, tax exempt financing is a tool which states and localities can use for the financing of public purpose projects. We do not agree with the 1 percent rule as a fair definition of public versus private purposes, but we do feel some restrictions can be developed to ensure that the use of this provision is in the public good.

I applaud, of course, your support of deductibility, and your understanding of the issue is very comprehensive. I believe perhaps the most important notion in the President's tax proposal is that the principal of federalism is embodied in deductibility.

There are many tax loopholes that remain untouched or in effect, such as: oil and gas depletion allowance; drilling expenses; excess fringe benefits; virtually unlimited mortgage interest deductions, regardless of the extravagance of the house or the fact of owning two, three or four residences; minimal curbs in deductions for business meals; and a new indexed depreciation schedule that could give away more money than the accelerated cost recovery system, which has been a major cause of many corporations escaping tax-free over the last 3 years.

I would also like to point out that it is entirely possible under the President's proposal to create more operations and therefore, again, allow the State and local deductions to occur.

I think that these exclusions and deductions do not match the critical importance of the deductibility of State and local taxes. One concern that I have is where the information is coming from.

On Tuesday our Governor met with the President and Treasury officials who indicated to Governor Brennan that 88 percent of middle income tax people did not itemize, and yet our own figures in Maine show that at least 25 percent of them do. I will tell you why. The State income tax in my State says that you cannot file a long form unless you have filed a long Federal form and the figure is 25 percent—we know that for a fact—besides those people who file Federal long form without filing long form at the State level.

And so the Treasury figures are simply in error. Where they got the facts, I don't know, but they are not based on any figures which came from Maine. If it is true in my State, I would suspect it is true in others.

The second point which I think is important, I heard Treasury's representative a few minutes ago say about one-fifth of the State and local taxes were being deducted, or that deductibility came from those sources, and that the State and local governments got the bulk of their income from sources other than State and local taxes.

Let me just tell you that in Maine, as an example, better than 85 percent of all local taxes generated at the local level are based on the property tax, nothing else. And at the State level, two-thirds of all taxes are based on the excise tax, which is deductible; the State income tax; and the sales tax. So that is in contradiction to Treasury, again. I make those two points just to illustrate, I think, the fact that their facts are simply inaccurate. Where they are getting the information, I think, ought to be investigated.

The State legislators are concerned about the impact the loss of deductibility would have on the need to fund improvements in our school systems to provide quality education, and the likelihood that in the near future, more responsibilities will be turned back to the States, which is occurring almost on a daily basis.

In this tax proposal itself, the proposed 1 percent rule to distinguish between taxable and tax-exempt bonds would change the status of two-thirds of the current bond market by Treasury's own estimate. We, in my State and other States, as well, have been struggling with the bond market simply to increase our capacity to get higher ratings on bonds to decrease the interest that we are charged. If this has an impact, as has been suggested by Standard & Poors, then I think we are going to be in severe trouble again, and the amount of interest that will be charged to do State functions is going to increase drastically.

Finally, let me just say that the question of unfairness in our Federal Tax Code is not generated by the deductibility of state and local taxes. Deductibility was there in 1913, and I think the basis upon which it exists is also here today as shown through the data.

I will submit the rest of this in my statement, Mr. Chairman.

Senator DURENBERGER. Very good. You have worked here before. That is terrific. [Laughter.]

Who do I introduce next, Bill?

Mr. SCHREIBER. Mr. Chairman, thank you. I am Bill Schrieber, a member of the Minnesota House of Representatives. I also serve as chairman of our Minnesota House Tax Committee. I believe it is particularly important to recognize you for your interest in caring about those other local units of government, meaning State and cities and counties, and that we have an opportunity to participate in this very meaningful debate.

We in Minnesota, Mr. Chairman, have just completed the special legislative session. Taxes were reduced by in excess of $860 million over the next 2 fiscal years, including substantial reform in August for a 17 percent reduction of the individual income tax. The rate of growth in State funding was reduced to 4.5 percent, approximately the rate of inflation. I should add that general fund spending will be nearly $400 million less than the Governor's recommendation.

In the reform of our State income tax, over 30 special gross reductions and deductions were repealed and lower tax rates enacted. However, we retained the full deductibility of Federal income, State sales and local property taxes in the competition of our State income tax base. This decision was based upon the fundamental consideration that the income tax base must measure the capacity or ability of the taxpayer to pay tax. Involuntary tax payments, whether they be Federal income taxes, State sales or income taxes or local property taxes, are dollars not available to the taxpayer and should not be used to measure the amount of income available to pay taxes.

I should note that this was a matter of some dispute in the legislative debate, since some legislators would have preferred to repeal of the Federal income tax deduction. However, in the final analysis, the decision was made to retain deduction.

As a little aside to this, trying to simplify is not an easy task. We were faced with some of the dilemma that I think Mr. Levin is talking about here, and that is talking about winners and losers. Somehow, in this whole debate, we need to talk about what is fair and not as compared to who is going to be the winners and who is going to be the losers.

Minnesota is a State which appears fiscally healthy and able to make the hard decisions, but let me add another dimension. Our economy is not as strong and as diverse as we would like it to be. The recent 1981 to 1983 recession took a greater toll than expected.

The recession in Minnesota was deeper and lasted longer than the Nation as a whole.

This was exactly the opposite of the Minnesota experience with recessions in the sixties and seventies. These facts taught us that Minnesota is changing and that to maintain our position as one of the more reliable and consistently performing State economies, we had to make changes to attract new industries, to encourage development of new industries within our State and to reshape our tax laws and our education and job training budgets to meet those needs.

I tell you this story to make two points: One is that proponents of the elimination of deductibility argue that it is necessary to eliminate deductibility in order to bring down excessive high State and local taxes. In Minnesota, the legislature is willing and able to take those steps, but to do so in the context of the needs of its taxpayers.

Second, even though the size of our 1985 tax cut makes us appear to be a wealthy or at least financially secure State, we are more dependent upon the national economy than we have been in the last decade or two. Any further slowing of growth in the economy or prolonged recession will cause major costs to our businesses and our citizens, resulting in a loss of State revenues and a need to increase State spending.

These are precisely the times when deductibility is most important. Over the good years, Minnesota regularly contributes more in Federal tax collections than it receives in Federal grants-in-aid and total Federal expenditures. We receive generally about 87 cents on the dollar for this money sent to the Federal Government. It is in recessions when we come closer to getting greater equity in this balance, as Federal aid is increased by the automatic triggers of unemployment and Federal tax collections are lowered by reductions in earnings, both individual and corporate. We are a nation which relies heavily on the State and local governments to provide a substantial share of government services, many of which are income-sensitive, such as medical care and income security for the poor. Some form of equalization on the capacity to provide these services is essential.

For example, in Minnesota, we have essentially two economies: one in the Minneapolis-St. Paul metropolitan area, which is fairly healthy and provides, by far, the most significant share of State revenues relative to population. The second economy consists of the remainder of the State, the agricultural areas and the iron range, which are far from healthy. State tax revenues garnered from individuals and businesses in the metropolitan area are used substantially to provide governmental services to the outstate regions for education and welfare aids. Elimination of the deductibility of State income or sales tax is likely to erode the willingness of taxpayers in the metropolitan area to subsidize, so to speak, those in the other areas of the States where economic activity is lagging. The deductibility of State and local taxes may not be a perfect equalization device, but it is the best that we have and should not be abandoned until we have something much better to replace it.

The need for Federal tax reform is great, but one may question the assertion of some that reform is impossible without sacrificing deductibility.

The President's tax reform proposal criticizes the State local tax deduction as a subsidy of itemizers by nonitemizers and of residents of high tax States by residents of low tax States. Accept this logic, all itemized deductions, home mortgage interest, charitable deductions and so forth, would appear to be a subsidy of itemizers by nonitemizers. I simply do not believe this is the case. It is a fundamental feature of measuring the ability to pay.

However, if it is the case, it bears pointing out the President's proposal retains other similar subsidies.

Senator DURENBERGER. See the red light?

Mr. SCHREIBER. That is it?

Senator DURENBERGER. Great. [Laughter.] Thank you very much.

Mr. SCHREIBER. OK.

Senator DURENBERGER. I have lost track. Who is next?

OK, Peter?

Mr. SHAPIRO. I am Peter Shapiro. I am the county executive of Essex County, NJ, and I am here representing the National Association of Counties (NACo). I am going to abbreviate my prepared text in an effort to stay within your time limit.

NACo supports fair and comprehensive tax reform, but not at the expense of local governments and their ability to serve their citizens.

Deductibility preserves the ability of State and local governments to raise revenues and to provide services, promotes equity in the Federal tax system and avoids excessive cumulative Federal/State and local income tax rates while preserving the historic independence of State and local governments.

I particularly want to emphasize the importance of property taxes. Property taxes are far the largest single revenue source for most county governments. Over 80 percent of county revenue is derived from property taxes. County governments use this tax base to fund an array of essential services including education, health care, environmental protection, infrastructure and law enforcement.

Nationwide polls show that this tax is the most disliked of all taxes, but it is the one tax that almost all local governments have direct control over, the one we partly own. A loss of deductibility makes counties' and most local governments' major revenue source more unattractive and more susceptible to taxpayer revolts. This further erodes our ability to provide and finance capital needs.

Some studies estimate the elimination of deductibility could cause a drop of 5 percent in property values themselves, threatening a principal source of family savings, equity, in their homes. Such a drop in values would also force lower property tax assessments, which obviously have a negative impact on local government revenue.

Moody's Investor Service projects this provision of the tax plan holds serious consequences for State and local credit. Reduced ability to raise needed revenue could cause sharp downgrades in municipal credit ratings and hence, higher costs of financing for counties and other localities. Our ability to build public-private partnerships will be greatly diminished.

In terms of public services, counties are one of those levels of government closest to the people and they are often the provider of last resort. We, currently, finance billions of dollars in necessary services and care. But if our hands are further tied when it comes time to raise money to pay the bills, public education, police, and fire, infrastructure needs and basic human services will be seriously undermined.

For example, education the largest single expense of State and local government comprises 40 percent of the total expenditures for the year 1982. The Congressional Research Service estimates that for every $1 of revenue that would be generated by repeal of this deduction, State and local governments would be forced to cut their budgets by 47 cents.

Ironically, and contrary to some assertions, in many instances, persons who pay State and local taxes receive little if any direct benefit from the services financed through those taxes. These funds are often redistributed to persons who are in need of health and welfare assistance, mental health and other essential services.

Based on my own accounting, I can tell you that the user fee model just plain doesn't work. Our three biggest cost items are the welfare system, the prisons, and community mental health. The people in need of these services, by and large, aren't paying the taxes for them. Therefore, they are costing us dollars. They do not have the funds available to pay user fees. I would be surprised if it wasn't very similar in most other local governments.

The proposed loss of deductibility of property taxes hasn't been clearly enough stated in the tax debate. The fact that people can deduct the cost of their property tax makes it possible for many millions of Americans to own a home. Homeownership and the sense of neighborhood and community pride it builds are fundamental to our American way of life. Most homeowners made the decision to buy a home, the biggest single financial commitment they will ever make, based on the knowledge that their property taxes would be deductible. In literally millions of cases, the President's proposal would severely disrupt individual families' personal financial plans.

Many who have just managed to fit the cost of homeownership within their family budget will now find them unable to do so. Countless other families and young couples hoping to be able to afford a first home will find themselves hopelessly priced out of the market, and many senior citizens, for whom the property tax has now been become the largest single part of their monthly cost of homeownership, will simply find they cannot make ends meet. For these taxpayers, loss of this deduction could make property taxes more regressive and therefore more onerous.

In summary, Mr. Chairman, I would like to say, on behalf of NACo and counties across the country, that we have supported the President and this Congress in their approach to "New Federalism." We think eliminating State and local tax deductibility would be an unfair move. This would impair our ability to administer necessary programs and we urge this step not be adopted.

Thank you. I would be happy to answer any questions.

Senator **Durenberger**. OK. Thank you.

Mayor Leafe, and then Marti. I saved the best for the last. We have a vote on, so I will let you proceed with your statement and then I am going to have to leave to go over and vote. If somebody has to leave in the meantime, I will sure understand that. We have two more witnesses behind this panel, as well, so you won't be alone if everyone else leaves.

Joe, thank you.

Mr. **Leafe**. Thank you, Mr. Chairman.

I am Joe Leafe and I serve as the vice-chair of the Finance, Administration and Intergovernmental Relations Committee of the National League of Cities and speak on behalf of the league in support of the continuation of the deductibility. I will speak just briefly and summarizing, as the others have, from the perspective of a central city, but also, from the perspective of a city that has maintained reasonably good economic health through the early part of the eighties, a city that has not been required to raise revenues or raise taxes, and through, we think, hard work and a little ingenuity and the use of the funds that we have gotten from the Federal level, been able to absorb the cuts that have taken place over this period of time.

We think we have used very well the revenue sharing, C.D. funds; the rehabilitation credits to entice investors in the city, and certainly, our bond financing ability as a city to come through with a very substantial rehabilitation and revitalization in our area. These are very important tools to us.

I think one of the points that I need to make and was better made by Senator Chiles a little earlier is that it is not just the deductibility. You can't look at it in a vacuum. It is the cumulative effect that is taking place, the cuts that have been made, and those that are proposed in one fashion or another, either in the deficit reduction budget or in the tax reform.

To our city, in the proposals that are on the table, we will lose in the neighborhood of $13 million, approximately 4 percent of our general operating budget. This does not take into account the cost to us from the substantial changes that are proposed in the bond area, the question of whether it is taxable or tax free. This will also be a substantial number.

If you add to that the figure that Mr. Pearlman referred to, the 1.5 to 2 percent cost to State and local governments through the elimination of deductibility, you put us at a point where we are dealing with 6 percent. That is more than we grow in our normal growth, and there is no way, as I sit here today, that we will be able to meet our obligations to assume these additional responsibilities that are being thrust upon us by the so-called new federalism without going back to our people for some additional revenue.

It is at that point that we run into the problem of deductibility and its cumulative effect on our overall efforts.

We don't oppose tax reform. We would certainly support simplification. I would say as an aside, I have great difficulty in finding simplification in what has been proposed, even though that word has been used from time to time. I think people will support a balanced program; will support simplification, but as it is on the table today, deductibility is the proverbial straw that breaks the camel's back. It is that extra burden that will make the difference in a city such as mine, and there is are certainly central cities that are in far worse shape than we are.

Thank you very much, Mr. Chairman.

Senator DURENBERGER. Thank you very much. Would you like to take a round, or are you on the 4:55 flight?

Ms. ZINS. I am here.

Senator DURENBERGER. I will have to recess the hearing until about probably about 3:35.

[A brief recess was taken.]

Senator DURENBERGER. The hearing will come back to order. I believe we have heard from four of our five panel members so far. Now, Ms. Marti Zins, president of the Minnesota Educational Association.

Marti, welcome. Your full statement will be made a part of the record. You may proceed to summarize it.

Ms. ZINS. Senator Durenberger and members of the subcommittee, my name is Marti Zins. I am a teacher in the Hopkins, Minnesota District, a national school of excellence, and am on leave to serve as the president of the Minnesota Education Association, which is an affiliate of the National Education Association. As such, I am greatly concerned by the recommendation of the current administration's recommendation to tax our State and local taxes and the overwhelming source of educational revenue.

In Minnesota, we are justifiably proud of our strong education system. The historical commitment on the part of Minnesotans enables our State to be a leader in educating all. Minnesota, for example, has consistently a high retention rate of the school-aged students, currently at 91 percent. But it is becoming more and more difficult to keep that level of commitment.

For instance, fewer than one in five of the households in Minnesota have school-aged children.

For instance, our rural economy is in a life-or-death struggle, and passing of a local property tax levy referendum for education is no better than a 50-50 proposition, be it metro or rural.

Now, if we eliminate the deductibility of local taxes, to begin taxing a tax, the chances of passing local school referenda virtually will be eliminated.

This proposal comes as experts in Washington and in St. Paul are telling us it is time to improve education.

I ask you to visit with teachers from each of your States so you can understand better the grave potential for harm to our public schools that will result from the elimination of deductibility of State and local taxes.

The potential damage of this proposal would touch every State and every classroom in every State.

That makes teachers mad. Because our historical commitment to public education helps make us a high-tax State, Minnesota would be one of the hardest hit States under this proposal. According to a study that we spoke of earlier today, Minnesota could lose an estimated $671 per pupil of revenue. That is a lot of money.

Put it in this kind of context: We have just completed a difficult session of the Minnesota Legislature, followed by an even more difficult special session which ended last Friday.

Despite a $1 billion surplus, we were able to increase per pupil spending with bipartisan support by only a little more than $200 during the 1985-87 biennium. Again, the proposal you are considering cuts us back $671 dollars per pupil.

This cannot be tolerated. Public education needs your support now, more than ever. From our point of view, elimination of the Federal deduction for State and local taxes is one of the most critical issues this Congress will face. One point repeated in nearly all of the reports about education is the need to raise teachers' salaries, a goal with which we wholeheartedly concur.

But if we continue to restrict the sources of funds available to our public schools, not only this recommendation but those affecting curriculum and students are worthless.

Already, this administration has cut back on meager Federal funds to education. Now, the administration is attacking our only other source, State and local taxes.

Governor Robb's comments on the Governors' commitment notwithstanding, we have a problem.

As the NEA gathers here in Washington this week for our annual Representative Assembly, some 200 Minnesotans will be discussing this issue with the 7,000 other delegates.

In summary, passage of this so-called reform on our tax system would jeopardize the fundamental support that people provide to our Nation's schools and the 40 million students being educated. It would slash the resources available to States and local governments for education programs, as well as for a variety of essential social services.

It would devastate hopes for enhancing American education and would cripple the educational reform now in progress and would translate as a tax hike, not a tax reform, for individuals and a revenue loser for State and local governments and would spell a clear disaster for American education.

Finally, this proposed tax reform would result in a form of double taxation, a tax on tax. In Minnesota, we care a lot about the future of education. I would like to believe that feeling is shared nationwide. Now is the time to enhance our investment in the schools of our Nation not to undermine that potential.

What is at stake? At stake is more than just dollars and cents. It is opportunity, the opportunity we could provide our children and the future we could build for our Nation. Thank you.

Senator DURENBERGER. Thank you very much.

It seems to me, as I listen to all the testimony, that one of the great problems we and the public have, besides understanding this issue, is trying to understand what fairness is as applied to this issue and then what the Federal role is in all of this.

I found one of the interesting comments that a lot of people made, and I think the two witnesses here from Minnesota pointed it out—maybe I understand it better because I am from there—is the business about the "two States" within Minnesota? We think about this sometimes as the difference among the States and the fiscal capacity of the States and the fact that New York City does have more undocumented workers, just in the city alone, than Wyoming has people, and some of those kinds of issues.

But it is even more interesting to know what goes on within a State and the varying capacity of portions of that State to meet its needs—willing legislature or no willing legislature; willing city council, county board or no willing city council.

We clearly have that in Minnesota, where you have two clear economies today, one half, the State's "dying" population, 99 percent of it in size, and the other 1 percent of it is going gangbusters. To the degree that taxes need to be raised locally to support local services, they aren't going to make it. For example, the Twin Cities and the metropolitan area could gang up on the rural area, and we are pretty close to be able to do that, if I see the numbers, if you want to work it that way, and they could say, "We aren't going to send any money out there." Then you would have questions about not only education, but a whole lot of other public services being subordinated; some of those other problems.

So I think that the point of a lot of this testimony from this panel is to tell us there isn't just a national tax role in the disparities among the States, but it is with people within a State or some other jurisdiction that suffers some degree of discrimination, which it is appropriate for a national government to care about, that kind of discrimination. Unless we literally adopt the theory of what we are defeating, we have to care about those things.

Mississippi, represented by the Senator who was here earlier, has half the tax capacity that Texas has. If they put the same tax rates on property income and consumption transactions in that state as they do in Texas, they would raise only half as much money as Texas would. A poor hungry kid in Mississippi is like a poor hungry kid in Texas, yet Mississippi has only half the money to spend on him.

I am sure these disparities exist within a State like Virginia. In Fairfax County, where I happen to live, it doesn't tax me very heavily, but it sure has the capacity to, compared to Rappahannock County or something like that.

The next issue is getting State and local governments to cut their spending. I am assuming you would agree with everything I have just said. This is a tougher issue, because all those taxpayers out there really are enticed by by the notion that somehow, they can pay less taxes out of this whole gismo that is being offered to them. Somehow they have got a deal that makes them pay 50 percent less tax, or something like that, without anybody suffering from it.

In fact, I took one sentence out of my opening statement here that said deductibility makes it easier for State and local government to raise taxes, because I will bet you a majority of the taxpayers in Minnesota would not want to hear their Senator say that. The mood that made Bill Schreiber be in the majority in the State of Minnesota for the first time in 14 years was to cut those taxes.

How do you cut taxes to balance a budget? By cutting spending. This is what I want you to comment on, that there is an effort here, in effect, to force State and local governments to cut spending. There is no question about that. I guess I would like each of you to make an argument why going at it from the deductibility side is not an appropriate way to force people to cut spending, especially if our objective is not only to get people to cut spending, but also to get people to spend money more wisely, which to some degree is happening already.

I think I sense a big push behind this elimination of deductibility is just that. I hear it from business people, "My gosh, if we can do anything more to discourage those legislators or those county commissioners or mayors from raising our taxes, do it."

Tell me why they are wrong and if this is a lousy approach. Bill, you were the first to testify.

Mr. **SCHREIBER**. Senator, I find that I have yet to hear a city councilman talk about raising taxes, and use the argument to his or her constituents that after all, when property taxes go up 20 percent, it is still deductible at the Federal level. That just is not going to sell back home.

So my judgment is that the deductibility issue is important, but by and large, local units of government have not been making spending decisions based upon the fact that the State and local taxes have been deductible at the Federal level. I don't think that is an argument that sells well with the taxpayer.

On the other hand, if you eliminate the deductibility, as is the administration proposal, I think it is going to have a rather dramatic impact, because folks are going to see it on the Federal income tax return as to the difference of the disparities from one State to another are going to be amplified; the disparities from one part of a State to another are going to be amplified.

We are experiencing that in Minnesota today with defining agricultural land values; with rather rapid business property tax values reductions.

What happened when the local units of government try to spend the same amount is just, you are doing it on a smaller base. That means the rates go up. You run into the dilemma of property taxes being three times higher in one portion of the State as compared to another on business properties, and simply, the business can't afford that, so they move out of that high tax area into either a low tax area within the State or else to another State. Then the problem is compounded, because you are losing the little tax base and job-producing enterprises that you have.

Senator **DURENBERGER**. Do you agree, when I asked Governor Robb about the fact that the deductibility goes in for businesses but goes out for individuals, that that would, in effect, encourage legislatures to go look more closely at business taxes which, then, just excels the existing economic competition?

Mr. **SCHREIBER**. That is right. Clearly, it would.

Senator **DURENBERGER**. That economic competition is very real; is it not?

Mr. **SCHREIBER**. Yes.

Senator **DURENBERGER**. It isn't just the way we perceive it in Minnesota.

Mr. **SCHREIBER**. It is very real, and you only have to look at the proposals to General Motors to locate the Saturn plant in Minnesota. When the State of Minnesota would commit itself to a billion-dollar program to get the Saturn plant located there, it defies imagination, quite frankly.

Senator **DURENBERGER**. Virginia is not a high-tax State. Why are you here? Don't you buy into Secretary Baker, who said repeal appears unfair to those speaking on behalf of the high-tax jurisdiction, only because there is not a soul biased in their favor. Buchanan says, "We do not believe in the neosocialist approach to government that redistributes wealth."

You ought to be a Buchanan or a Baker, right?

Mr. LEAFE. I should be on the winners' side and say, "Go ahead and do it. In the long run it would benefit my State."

My view is on the long run, it would not be of benefit. I think as you pointed out, Mr. Chairman, the difference in the ability of Mississippi versus Texas, for instance, and there is a lot, there is a whole range of differences and ability across the States and within the same states.

So I don't think you could afford to look at it on the basis of whether I win on this particular issue. Just as State legislatures can't afford to look at it having had some experience there, I know that that comes up often in arguments of who wins with the distribution of this tax or who doesn't.

So I think you just have to look at it in a broader sense and look at some basic fairness and the question of what you do with the whole Federal system.

Senator DURENBERGER. Is the NLC position still just opposed to the Treasury proposal?

Mr. LEAFE. Yes; the NLC's position, yes.

Senator DURENBERGER. They don't endorse an alternative?

Mr. LEAFE. No.

Senator DURENBERGER. And the National Association of Education is in the same position, I take it? They are opposed to the tax reform proposal. They don't have a position?

Ms. ZINS. We don't have a position, right.

Senator DURENBERGER. They don't have an alternate position relative to deductibility as of yet?

Ms. ZINS. We do not have an alternate position.

Senator DURENBERGER. Bill, I don't know whether you drafted this, I doubt it if you were busy, or NCSL did, but while they compliment S. 315, my 1 percent of the adjusted gross income approach, they say, "your proposal of a floor would hinder many States from supporting it, because the 1 percent might render the remaining deductibility of little or no use, given their tax bills, and without more benefits, it would be difficult for them to support what is a politically difficult vote."

Do you have any idea what that means? Is that referring to Wyoming where State and local taxes are 2.790 percent AGI?

Mr. SCHREIBER. Yes; talking about the low tax States and the fact that the 1 percent floor would not be of a significant benefit in that that even increases the taxes beyond that point. It would be not certainly politically popular, but I don't think any tax increases for anyone are popular.

Mr. LEAFE. Clarifying on NLC, we are talking about deductibility, in their position, maintaining deductibility as far as reform itself. I think there is support to the overall concept of tax reform.

I am not speaking for NLC, but speaking individually. In your 1 percent proposal, I think it certainly is a step in the direction of compromise on a difficult issue. But you worry about those who have the objective of eliminating, and sometimes you eliminate in two bites just as well as in one, and 1 percent may be good for this year, but when next year rolls around and there is still a $200 billion deficit sitting out there, the spots are going to be hard to find.

Senator DURENBERGER. That is why I hope all these associations will not make the mistake that NACo did, and I was going to say when Mr. Shapiro was here, and I think NLC made 2 years ago when we tried to reform the general revenue sharing formula to get it more needs-based. Now they are going to eliminate it entirely.

If you end up on deductibility, for 2 years I have said this, whether your issue is tax reform or like Chuck Robb, to raise that money to cut the deficit, somebody is going to get that deductibility. As long as the interest groups for State and local government go like this, you are going to lose what friends you have got up here.

I do hope that people can help us look for, if there is a better alternative than S. 315. Boy, I will get on it and cosponsor it with somebody else. I think that is part of the reality we need to deal with.

Well, thank you all very much. I really appreciate your being here, staying here this long, and I am sorry we had a tough day, but this is the first hearing on the subject. I hope you will keep coming back. I know we are having one in the Finance Committee about the third week in July. So you will probably be around for that, too.

Thank you all very much.

[The prepared statements of Messrs. Martin, Schreiber, Shapiro, Leafe, and Ms. Zins follow:]

PREPARED STATEMENT OF JOHN MARTIN

Mr. Chairman, I thank you for this opportunity to bring you both my concerns and those of the National Conference of State Legislatures on the issue of the deductibility of state and local taxes.

My name is John L. Martin and I serve as the Speaker of the Maine House of Representatives, a position I have held for ten of the twenty-one years I have been a House member. I am also here today in my capacity as Chairman of the State Federal Assembly of the National Conference of State Legislatures.

Let me begin by congratulating you for your forthright defense of the principle of the deductibility of state and local taxes. Your position as Chairman of the Senate Intergovernmental Relations Subcommittee is an important one in this debate. Your thoughtful and strong statements in support of deductibility as a basic and essential component of federalism have been important to the tax reform debate. I must, however, voice opposition to your proposal for a compromise position on this issue.

Your understanding of the arguments for deductibility is deep and genuine. There is no need for me to try to persuade you in this area. Instead I'd like to focus on the tax reform issue, since your proposal begins with the notion that the current tax reform proposal is important to the country, perhaps as important as federalism. Here, I believe, we part company. When NCSL looked at the issue of federal tax reform, we chose to draft a statement which laid out principles which we felt underlie any federal tax policy. Therefore if and when reform was being discussed, these principles could be made a part of that discussion. I have attached a copy of our policy to my statement.

A first and major concern was that federal tax policy not be changed retroactively. State legislatures must craft and adopt balanced budgets, and when our sessions adjourn, a delicate balance has been struck. We also try, for ease of taxpayer compliance, to use points of reference, definitions and concepts from federal tax law. Thus if federal tax changes are retroactive, our budgets are very likely out of balance even though we have acted in accord with good and sound principles.

Secondly, state legislators feel that deductibility is an essential part of the tax code, and that it represents a key ingredient of the decision by the states in 1913 to give the federal government the power to establish an income tax. We are unwilling to surrender this protection for our citizens and our tax bases.

Thirdly, we adopted a statement which argues that tax exempt financing is a tool which states and localities can use--and should be able to continue to use--for the financing of public purpose projects, many of which are mandated by Congress and the courts. We do not agree with the 1% rule as a fair definition of public vs. private purpose, but we do feel some restrictions can be developed to insure that the use of this provision is in the public good.

Mr. Chairman, we did not attempt to draft a tax reform proposal. Therefore these principles do not attempt to say how base broadening and rate reductions are to be balanced. But your proposal does make a statement on that basis, and it judges that part of the base broadening must include at least a portion of the deductibility of state and local taxes. My view of the President's proposal is that more base broadening is needed, but that deductibility has no need to be sacrificed. Many tax loopholes remain untouched or barely affected, such as oil and gas depletion allowances and drilling expensing; excluded fringe benefits; virtually unlimited mortgage interest deductions regardless of the extravagance of the house or the fact of owning 2,3 or 4 residences; minimal curbs on deductions for business meals and entertainment; and a new indexed depreciation schedule that gives away more money than the Accelerated Cost Recovery System (ACRS), which has been a major cause of many corporations escaping tax-free for the last three years.

Mr. Chairman, these exclusions and deductions do not match the critical importance of the deductibility of state and local taxes. How can you insist on compromising such an essential component of our federal system to protect them? This is not a one or two year trial period. If deductibility is ended, it is ended for the next 10, 20, 50 years. Already states and localities have been called on to bail out the federal government by major reductions in aid, constant mandates for services or programs which the federal government is unwilling to support financially. In this tax proposal itself, the proposed 1% rule to distinguish between taxable and tax-exempt bonds would change the status of two-thirds of the current bond market by Treasury's own estimates: 80% of the market by other estimates. I will not argue that all of these bonds are currently "public purpose". NCSL is willing to discuss reasonable and effective restrictions, but 66% is a very high portion of tax-exempt financing for state and local governments to fund through other means.

Even if we are able to retain deductibility, the fiscal picture for states is becoming more and more precarious. These new responsibilities will require tax increases which our citizens may not support. The role and responsibilities of government are shifting and states and localities are ever more placed in a squeeze.

Your compromise does not call for an end to deductibility. But let me remind you that one or two years ago when you began to shape your proposal, you included in the package as compensation for the loss in the value of deductibility a $6 billion revenue sharing program to be turned back to the states. What happened to that component? It became politically impossible. It is my belief that the institution of a 1% floor will lead to a 2%

floor, 3%, 4%, until the provision has disappeared. Once the principle is up for discussion, we lose power to control it.

NCSL has adopted a clear policy to continue deductibility. State legislators are concerned about the impact its loss would have on the need to fund improvements in our school systems to provide quality education, and the likelihood that in the near future more responsibilities will be turned back to states and localities from the federal government which will require additional revenues; programs like wastewater treatment plants, resource recovery and hazardous waste disposal. What kind of intergovernmental relationship do we have if one level can dictate new responsibilities to the other and at the same time begin to tax the revenues which that level of government must raise to meet these responsibilities? This double taxation is also a threat to all of the services we now provide.

So-called "high tax states" and "low tax states", high income states and low income states all recognize that this provision is essential and that there is no compelling need to sacrifice it to tax reform. The outcry over unfairness in the federal tax code was not in any way generated by the deductibility of state and local taxes; it began with the realization that the wealthy and many large corporations had almost unlimited ways to hide their income from taxation.

Retention of deductibility not only preserves an important federal principle, it also provides a beneficial deduction for middle income Americans. Over 75% of those who deduct state and local taxes earn less than $40,000 annually.

Retention of deductibility is based upon the ability-to-pay principle and avoids what President Reagon termed in 1983 "the imposition of a tax on a tax".

The tax reform which we need is not in the President's package. The loopholes still remain. And financing a tax cut in the name of tax reform on the backs of states and localities is a mistake and a danger to our federal system. The state-by-state analyses are showing that overall, taxpayers in every state benefit from the package because it is not revenue neutral. But the federal government can ill afford to give away another $11 to $13 billion.

The proposal increases the burden on middle income taxpayers and inordinately favors the wealthy. A congressional study has pointed out that income categories between $0 and $100,000 per year will reap between $104 and $250 dollar tax cuts per taxpayer, while taxpayers earning $100,000 to $200,000 will receive $686, and those earning over $200,000 will receive $9,254 each. That is not a plan which responds to the outcry over unfair taxes, and ending deductibility to ensure its adoption is not in the best interests of this country. I ask you to change your position on this compromise and join state legislators and other elected state and local officials to preserve deductibility.

Thank you. I'd be glad to answer any questions you might have.

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Statement on Federal Tax Policy

Adopted May 10, 1985

The National Conference of State Legislatures believes that federal tax policy is an integral part of an effective, fair and efficient federal system. With a broad debate already developing on the topic of reforming the federal tax system, the NCSL calls on the Administration and the Congress to enact tax policy which respects state revenue systems. Three points are key to that concern:

1. State and federal taxes are both intended to meet public needs; thus further competition for existing tax bases is inefficient and undesirable. The federal government should continue to rely on the income tax as its best and primary source of revenue. A federal decision to initiate an entirely new tax such as a value added or a consumption tax would result in greater federal administrative costs and increased difficulty for state and local revenue decisions.

2. The deductibility of state and local sales, income and property taxes provides a protection against federal taxation of income used to pay state and local taxes. Such a deduction furthers the national goal of respecting the integrity of state and local tax bases, assuring states and localities of adequate sources of revenue to fulfill their appropriate responsibilities.

3. The right to issue tax-exempt bonds to support capital improvements is fundamental to the capacity of state and local governments to discharge their responsibilities under the federal system. Federal tax policy should not be made which would attempt to limit or encroach upon this source of financing for basic state and local government needs. The state and local government responsibility for these services requires the support of the federal governnrment to assure adequate financing.

Equally important to states, federal tax policy must be in accord with the following:

4. Tax policy must support sound fiscal policy. Continued, predictable economic growth is essential for the fiscal stability of state governments.

5. Adequate revenues are the concern of both the states and the federal government. Whether the responsibility for a public service is shared, purely state or federal, failure to provide the promised and needed service forces an additional burden on other levels of government. Federal revenues must be adequate to support appropriate federal responsibilities.

6. Major federal tax policy proposals often affect state tax systems. Thus, there must be consultation and cooperation between federal and state policy makers. Any proposed changes in federal tax policy must include sufficient time for states to make corresponding changes as desired or needed. In no event should federal tax changes be retroactive, depriving states of duly deliberated and legislated revenues.

7. Since 1980, federal tax rates have declined substantially. However, state tax increases have consistently been needed because of a sluggish economy, additional responsibilities assumed by the states within our federal system, and because states are required to have balanced budgets. Operating surpluses of state governments are not a signal that the federal government should cut back on its responsibilities; rather they are the product of responsible state tax and budgetary policies. Changes in federal tax policy should not penalize states for having acted responsibly these past four years.

The NCSL understands that ease of compliance and effectiveness of enforcement are crucial to tax policy at all levels of government. We further believe that fairness and efficiency are standards needed to guarantee that genuine public needs are met in an equitable manner.

PREPARED STATEMENT OF WILLIAM SCHREIBER

Mr. Chairman, I thank you for the opportunity to testify today on the deductibility of state and local taxes, which is a very controversial part of the debate on federal tax reform. My name is Bill Schreiber. I serve as a member of the Minnesota House of Representatives and am the chairman of the House Tax Committee. I am testifying both on behalf of the National Conference of State Legislatures and in my capacity as a Minnesota legislator.

Let me begin by congratulating you for your forthright defense of the priniple of the deductibility of state and local taxes. Your position as Chairman of the Senate Intergovernmental Relations Subcommittee is an important one in this debate. Your thoughtful and strong statements in support of deductibility as a basic and essential component of federalism have added clarity to what most often has been an emotional, inaccurate or poorly focused argument.

A first and major concern of NCSL is that federal tax policy not be changed retroactively. State legislatures must craft and adopt balanced budgets, and when our sessions adjourn a delicate balance has been struck. We also try, for ease of taxpayer compliance, to use points of reference, definitions and concepts from federal tax law. Thus if federal tax changes are retroactive, our budgets are very likely out of balance even though we have acted in accord with good and sound principles.

Secondly, state legislators feel that deductibility is an essential part of the tax code, and that it represents a key ingredient of the decision by the states in 1913 to give the federal government the power to establish an income tax.

Thirdly, NCSL has adopted a statement which argues that tax exempt financing is a tool which states and localities need--and will continue to need--for the financing of public purpose projects, many of which are mandated by the Congress and the courts. We do not agree with the 1% of bond proceeds rule as a fair definition of public vs. private purpose, but we do feel some restrictions can be developed to insure that the use of these bonds is for a public purpose.

Mr. Chairman, as you know, the Minnesota legislature just finished a special session devoted to fiscal issues. We have recessed until next February and completed action on our biennial budget by lowering taxes and reducing the rate of growth in state spending. Taxes were reduced in excess of $860 million over the next two fiscal years, including a substantial reform of and 17 percent reduction in the state income tax. The rate of growth in state spending was reduced to 4.5 percent, approximately the rate of inflation.

In the reform of our state income tax, just enacted, over 30 different special subtractions from gross income, itemized deductions, and credits were repealed and lower tax rates enacted. However, we retained full deductibility of federal income, state sales, and local property taxes in the computation of our state income tax base. This decision was based on the fundamental consideration that the income tax base must measure the capacity or ability of the taxpayer to pay tax. Involuntary tax payments, whether they be federal income taxes, state sales or income taxes, or local property taxes, are dollars not available to the taxpayer and should not be used to measure the amount of income available to pay tax. I should note that this was a matter of some dispute in the legislative debate, since some legislators would have preferred to repeal the federal income tax deduction. However, in the final analysis the decision was made to retain the deduction.

Having painted a picture of a state which appears fiscally healthy and able to make the hard decisions, let me add another dimension. Our economy is not as strong and diverse as we'd like it to be. The recent 1981-1983 recession took a greater toll than expected and showed the effects of national industrial changes and national farm policies and national demographics on Minnesota. We had more people out of work longer relative to other states during the previous recession. We had a significant share of the farm foreclosures that took place around the country. We had more displaced workers among our unemployed than during previous recessions.

These facts taught us that Minnesota is changing, and that to maintain our position as one of the more reliable and consistently performing state economies, we had to make changes to attract new industries, to encourage the development of new industries within our state, and to reshape our tax laws and our education and job training budgets to meet these needs.

I tell you this story to make two points: one is that proponents of the elimination of deductibility argue that it is necessary to eliminate deductibility in order to bring down excessively high state and local taxes. In Minnesota the legislature is willing and able to take those steps, but to do so in the context of the needs of its taxpayers.

Even though the size of our 1985 tax cut makes us appear to be a wealthy or at least financially secure state, we are more dependent on the national economy than we have been in the last decade or two. Any further slowing of growth in the economy or prolonged recession will cause major costs to our businesses and our citizens, resulting in a loss of state revenues and a need to increase state spending. These are precisely the times when deductibility is most important. Over the good years Minnesota regularly contributes more in federal tax collections than it receives in federal grants-in-aid and total federal expenditures. It is during recessions when we come closest to getting greater equity in this balance as federal aid is increased by the automatic triggers of unemployment and federal tax collections are lowered by reductions in earnings--both individual and corporate. For the past year, FY 1984, Minnesota's citizens contributed $11,389 million in support for the federal government, but received only $10,591 million in total federal spending. Figures from the Congressional Research Service show that Minnesotans get back $.87 on the dollar for the money we send the federal government.

Minnesota taxpayers have a lot to lose through the loss of deductibility. It is argued by some in Washington that other states have a lot to gain. However, those states are by and large the same states which receive more back from the federal government than their citizens pay in federal taxes. If one side of this equation is ended, how long can the other last?

Furthermore, in a nation which relies heavily on state and local governments to provide a substantial share of government services--many of which are income sensitive, such as medical care and income security for the poor--some form of equalization of the capacity to provide those services is essential. For example, in Minnesota we have essentially two economies, one in the Minneapolis-St. Paul metropolitan area which is fairly healthy and provides by far the most significant share of state revenues relative to population. The second economy consists of the remainder of the state--the agricultural areas and the iron range--which are far from healthy. State tax revenues garnered from individuals and businesses in the metropolitan area are used substantially to provide governmental services to the outstate region for education and welfare aids. Elimination of the deductibility of state income and sales taxes is likely to erode the willingness of taxpayers in the metropolitan area to "subsidize" those in the other areas of the states where economic activity is lagging. The deduction for state and local taxes may not be a perfect equalization device, but it is the best that we have and should not be abandoned until we have something much better to relace it.

Elimination of the deductibility of state and local taxes will affect the ability of state and local governments to raise revenues. This would occur at the same time that the federal budget is very likely to reduce grants-in-aid to state and local governments as part of the deficit reduction effort. The President's budget recommended that state and local government grants-in-aid be cut by about $7 billion or 6 percent in nominal dollars over fiscal year 1985. Since inflation is estimated by the administration to be increasing at an annual rate of 4.3 percent, this is a much more significant cut in real terms.

If one views the deduction for state and local taxes as a tax expenditure--and I realize the tax expenditure concept is a somewhat controversial topic--this would constitute an additional loss of approximately $36 billion, again using the President's budget estimates. To me as a state official this seems like adding insult to injury or being asked to give at home after giving at the office.

I would like to comment on the proposals which you have made in regard to deductibility. You have offered it with the fullest expressions of support for the principle of deductibility, and you have structured it in a way which preserves a good measure of the evening out among states with varying tax rates which it now provides. Your proposal also strikes a balance between the assertions of the Treasury Department about $33 billion in revenues foregone by reducing the cost of the deduction. You also keep all taxes in the package, preventing the unintended outcome of states shifting the structure of their tax bases to take advantage of the remaining deductibility.

There are, however, drawbacks to your proposal. For example, your proposal of a floor would hinder many states from supporting it because the 1 percent might render the remaining deductibility of little or no use, given their tax bills and without more "benefits" it will be difficult for them to support what is a politically difficult vote.

The notion of compromise is at the core of politics and I applaud you for your candor, your willingness to try to develop solutions to critical problems.

The need for federal tax reform is great. But one may question the assertion of some that reform is impossible without sacrificing deductibility. The President's tax reform proposal criticizes the state and local tax deduction as a subsidy of itemizers by nonitemizers and of residents of high tax states by residents of low tax states. Accepting this logic, all itemized deductions (home mortgage interest, charitable contributions, and so forth) would appear to be a subsidy of itemizers by nonitemizers. I simply do not believe this is the case; it is a fundamental feature of measuring the ability to pay.

However, if it is the case, it bears pointing out that the President's proposal retains other similar "subsidies". One may question why these "subsidies" should have a higher priority than retention of the state and local tax deduction. Is it more important to encourage taxpayers to borrow money to buy cars, vacation homes, and other goods or to take vacations (provided the interest charges don't exceed $5,000 per year), rather than to pay taxes to provide education for elementary and secondary school children or medical care and minimal income security for the poor? I think not. Fundamentally, it is a matter or priorities and I urge you to give a very high priority to preservation of a healthy system of federalism by retaining the deductibility of state and local taxes.

Thank you. I'd be glad to answer any questions you might have.

STATEMENT OF THE HONORABLE PETER SHAPIRO, COUNTY EXECUTIVE, ESSEX COUNTY, NEW JERSEY AND VICE CHAIRMAN, STEERING COMMITTEE ON TAX AND FINANCE OF THE NATIONAL ASSOCIATION OF COUNTIES, BEFORE THE SUBCOMMITTEE ON INTERGOVERNMENTAL RELATIONS, U.S. SENATE.

GOOD AFTERNOON, MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE, I AM PETER SHAPIRO, COUNTY EXECUTIVE OF ESSEX COUNTY, NEW JERSEY. I AM HONORED TO BE HERE TODAY REPRESENTING THE NATIONAL ASSOCIATION OF COUNTIES (NACo)* AND EXTEND MY APPRECIATION TO YOU FOR THE OPPORTUNITY.

I AM HERE TODAY ON BEHALF OF COUNTIES NATIONWIDE TO DISCUSS WITH YOU THE ISSUE OF STATE AND LOCAL TAX DEDUCTIBILITY. NACo OPPOSES THE ELIMINATION OR REDUCTION IN STATE/LOCAL TAX DEDUCTIBILITY. NACo CURRENTLY HAS NO POLICY SUPPORTING A COMPROMISE. HOWEVER, WE WILL BE DISCUSSING, MR. CHAIRMAN, YOUR PROPOSAL TO LIMIT DEDUCTIONS TO THE AMOUNT EXCEEDING 1% OF A TAXPAYER'S ADJUSTED GROSS INCOME AT OUR TAX AND FINANCE MEETING IN ORLANDO NEXT MONTH. IN THAT REGARD, WE THANK YOU FOR YOUR EFFORTS AND CONCERN ON THE ISSUE. WE ARE ALARMED THAT AS THIS ADMINISTRATION AND CONGRESS BEGIN WORK ON TAX REFORM, THEY HAVE ONCE AGAIN LUMPED STATE AND LOCAL GOVERNMENTS INTO THE BROAD CATEGORY OF SIMPLY YET ANOTHER SPECIAL INTEREST GROUP. THE TAXPAYERS AND CITIZENS THAT HAVE COLLECTIVELY ELECTED THE PRESIDENT, VOTED IN THE MEMBERS OF CONGRESS AND THIS COMMITTEE, ARE THE SAME ONES WHO ELECTED ME AND MY FELLOW COUNTY OFFICIALS AROUND THE COUNTRY. OUR INTEREST, MR. CHAIRMAN, IS QUITE SIMPLY, THE PUBLIC INTEREST. AND FOR THAT REASON WE SUPPORT FAIR AND COMPREHENSIVE TAX REFORM -- BUT NOT AT THE EXPENSE OF LOCAL GOVERNMENTS, AND THEIR ABILITY TO SERVE THEIR CITIZENS.

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* The National Association of Counties is the only national organization representing county government in the United States. Through its membership, urban, suburban and rural counties join together to build effective, responsive county government. The goals of the organization are to: improve county government; serve as the national spokesman for county government; act as a liaison between the nation's counties and other levels of government; achieve public understanding of the role of counties in the federal system.

THE PROVISION IN THE FEDERAL INCOME TAX CODE THAT ALLOWS TAXPAYERS TO DEDUCT THEIR STATE AND LOCAL TAX PAYMENTS FROM THEIR FEDERAL TAXABLE INCOME IS A FUNDAMENTAL STATEMENT OF THE HISTORICAL RIGHT OF STATE AND LOCAL GOVERNMENTS TO RAISE REVENUES AND TAXPAYERS NOT TO BE SUBJECTED TO DOUBLE TAXATION. EVEN AT THE HEIGHT OF THE CIVIL WAR WHEN THE EMERGENCY FEDERAL INCOME TAX WAS ENACTED, LOCAL TAXES WERE DEDUCTED BEFORE COMPUTING INDIVIDUAL LIABILITY. WHEN THE CURRENT FEDERAL INCOME TAX WAS INTRODUCED IN 1913, STATE AND LOCAL DEDUCTIBILITY WAS AND HAS REMAINED A KEY PROVISION.

DEDUCTIBILITY PRESERVES THE ABILITY OF STATE AND LOCAL GOVERNMENTS TO RAISE REVENUES AND TO PROVIDE SERVICES, PROMOTES EQUITY IN THE FEDERAL TAXING SYSTEM, AVOIDS EXCESSIVE CUMULATIVE FEDERAL/STATE/LOCAL INCOME TAX RATES, AND HELPS PRESERVE THE HISTORIC INDEPENDENCE OF STATE AND LOCAL GOVERNMENTS.

PROPERTY TAXES:

THE PROPERTY TAX IS BY FAR THE LARGEST SINGLE REVENUE SOURCE FOR MOST COUNTY GOVERNMENTS. OVER 80% OF COUNTY REVENUE IS DERIVED FROM PROPERTY TAXES. COUNTY GOVERNMENTS USE THIS TAX BASE TO FUND AN ARRAY OF ESSENTIAL SERVICES INCLUDING EDUCATION, HEALTH CARE, ENVIRONMENTAL PROTECTION, INFRASTRUCTURE, AND LAW ENFORCEMENT.

THE DEMAND FOR THESE SERVICES IS EXPANDING: YET PROPERTY TAXES ALREADY ARE RESTRAINED. TAXPAYER REVOLTS, LIKE PROPOSITION 13 IN CALIFORNIA AND PROPOSITION 2-1/2 IN MASSACHUSETTS, HAVE OCCURRED IN THIRTY-FIVE STATES. SIMILARLY, COUNTIES IN MANY STATES -- INCLUDING MY OWN -- ARE RESTRICTED FROM RAISING TAXES BY STATE LAWS WHICH PLACE CEILINGS ON PROPERTY TAX INCREASES.

NATIONWIDE POLLS SHOW THAT THIS TAX IS THE MOST DISLIKED -- BUT IT IS THE ONE TAX ALMOST ALL LOCAL GOVERNMENTS HAVE DIRECT CONTROL OVER. LOSS OF DEDUCTIBILITY MAKES COUNTIES' MAJOR REVENUE SOURCE MORE UNATTRACTIVE AND MORE SUSCEPTIBLE TO TAXPAYER REVOLTS. THIS FURTHER ERODES OUR ABILITY TO PROVIDE AND FINANCE CAPITAL NEEDS

SOME STUDIES HAVE ESTIMATED THAT THE ELIMINATION OF DEDUCTIBILITY COULD CAUSE A 5% DROP IN PROPERTY VALUES THREATENING A PRINCIPAL SOURCE OF FAMILY SAVINGS -- EQUITY IN THEIR HOMES. SUCH A DROP IN VALUES WOULD ALSO FORCE LOWER PROPERTY TAX ASSESSMENTS WHICH WOULD OBVIOUSLY HAVE A NEGATIVE IMPACT ON LOCAL GOVERNMENT REVENUES. NOT ONLY WILL WE BE CONSTRAINED FROM FINDING NEW REVENUES TO MEET THE EVER GROWING DEMANDS PLACED ON LOCAL GOVERNMENTS -- BUT THIS CURTAILMENT OF REVENUES WOULD MAKE IT MORE DIFFICULT FOR US TO MAINTAIN WHAT WE DO HAVE.

CREDIT RATINGS:

MOODY'S INVESTOR SERVICE PROJECTS THAT THIS PROVISION OF THE TAX PLAN HOLDS SERIOUS CONSEQUENCES FOR STATE/LOCAL CREDIT. REDUCED ABILITY TO RAISE NEEDED REVENUE COULD CAUSE SHARP DOWNGRADINGS IN MUNICIPAL CREDIT RATINGS, HENCE HIGHER COSTS OF FINANCING FOR COUNTIES. OUR ABILITY TO AFFECT ECONOMIC BEHAVIOR AND TO BUILD PUBLIC-PRIVATE PARTNERSHIPS -- A PHILOSOPHY OF THIS ADMINISTRATION WHICH COUNTIES WHOLEHEARTEDLY SUPPORT -- WILL BE GREATLY DIMINISHED. THESE PROJECTIONS ARE EVEN MORE SERIOUS WHEN THE LOSS OF DEDUCTIBILITY IS CONSIDERED, TOGETHER WITH OTHER PROVISIONS OF THE TAX BILL, SEVERELY RESTRICTING LOCAL GOVERNMENT GENERAL OBLIGATION AND INDUSTRIAL DEVELOPMENT BONDS. THE PUBLIC SECURITIES ASSOCIATION ESTIMATES THAT 62-80% OF GENERAL OBLIGATION BONDS WILL NOW BE TAXABLE IF TREASURY II PASSES.

PUBLIC SERVICES:

COUNTIES ARE CLOSEST TO THE PEOPLE AND ARE OFTEN THE PROVIDERS OF LAST RESORT. WE CURRENTLY FINANCE BILLIONS OF DOLLARS IN NECESSARY SERVICES AND CARE. BUT IF OUR HANDS ARE FURTHER TIED WHEN IT COMES TO MONEY TO PAY THE BILLS -- PUBLIC EDUCATION, POLICE AND FIRE, INFRASTRUCTURE NEEDS AND BASIC HEALTH AND HUMAN SERVICES WILL BE SERIOUSLY UNDERMINED.

FOR EXAMPLE, EDUCATION IS THE LARGEST SINGLE EXPENSE OF STATE AND LOCAL GOVERNMENTS, COMPRISING 40% OF TOTAL EXPENDITURES IN 1982. THE TAX DEDUCTIBILITY PROVISION ACCOUNTS FOR $12.7 BILLION THAT IS SPENT ON ELEMENTARY AND SECONDARY SCHOOLS AND $3.8 BILLION THAT IS APPROPRIATED FOR HIGHER EDUCATION. THE CONGRESSIONAL RESEARCH SERVICE ESTIMATES THAT FOR EVERY $1.00 OF REVENUE THAT WOULD BE GENERATED BY REPEAL OF THIS DEDUCTION, STATE AND LOCAL GOVERNMENTS WOULD BE FORCED TO CUT THEIR BUDGETS BY 47 CENTS. UNDOUBTEDLY, EDUCATION WOULD BEAR A SUBSTANTIAL PORTION OF ANY LOSS IN REVENUE TO STATE AND LOCAL GOVERNMENTS RESULTING FROM FEDERAL REPEAL OF THIS DEDUCTION.

THE ADMINISTRATION MAINTAINS THAT THE TAX PACKAGE PROVIDES RELIEF TO LOW INCOME PEOPLE. HOWEVER, IN ORDER TO FULLY WEIGH THE IMPACT THAT TREASURY II WOULD HAVE ON LOW INCOME AND POOR PEOPLE WE MUST LOOK, NOT ONLY AT TAXES THAT PERSONS WITH MODEST INCOMES ARE REQUIRED TO PAY, BUT ALSO AT SERVICES TO POOR PEOPLE THAT ARE LIKELY TO BE CURTAILED AS A RESULT OF THE ELIMINATION OF STATE AND LOCAL TAX DEDUCTIBILITY. IN MANY INSTANCES, PERSONS WHO PAY STATE AND LOCAL TAXES RECEIVE LITTLE IF ANY DIRECT BENEFIT FROM SERVICES FINANCED THROUGH THESE TAXES. THESE FUNDS ARE REDISTRIBUTED TO PERSONS WHO ARE IN NEED OF HEALTH AND WELFARE ASSISTANCE, MENTAL HEALTH, AND OTHER ESSENTIAL SERVICES.

INTERSTATE ISSUES:

ADVOCATES OF THE ADMINISTRATION'S TAX REFORM PROPOSAL ARGUE THAT IT IS UNFAIR FOR TAXPAYERS IN LOW TAXING STATES TO SUBSIDIZE BUDGETS IN HIGH TAXING STATES. THIS POSITION OVERLOOKS THE FACT THAT SOME COUNTIES WITH HIGH TAX RATES, INCLUDING MANY COUNTIES IN MY OWN STATE OF NEW JERSEY, TRADITIONALLY HAVE HAD A DISPROPORTIONATE SHARE OF LOW INCOME AND INDIGENT PERSONS WHO ARE IN NEED OF A WIDE RANGE OF SERVICES WHICH ARE FUNDED WITH REVENUE DERIVED FROM STATE AND LOCAL TAXES. FURTHERMORE, ANY DISCUSSION OF SUBSIDIES BETWEEN STATES MUST TAKE INTO ACCOUNT THE NET IMPACT OF ALL INTERSTATE SUBSIDIES IN THE TAX CODE, PARTICULARLY THOSE BENEFITTING ENERGY PRODUCING STATES. IN FACT, AS THOSE STATES FACE CRISES IN THEIR TRADITIONAL INDUSTRIES AND FIND THAT THEY MUST TURN TO ALTERNATIVE SOURCES OF REVENUE, THEY WILL FIND GREATER RESISTENCE TO DOING SO WITH THE LOSS OF DEDUCTIBILITY.

FAIRNESS:

THE DEDUCTIBILITY OF PROPERTY TAXES HAS A SPECIAL IMPORTANCE WHICH HASN'T BEEN CLEARLY ENOUGH STATED IN THIS TAX DEBATE. THE FACT THAT PEOPLE CAN DEDUCT THE COST OF THEIR PROPERTY TAXES MAKES IT POSSIBLE FOR MANY MILLIONS OF AMERICANS TO OWN A HOME. HOME OWNERSHIP AND THE SENSE OF NEIGHBORHOOD AND COMMUNITY PRIDE IT BUILDS ARE FUNDAMENTAL TO OUR AMERICAN WAY OF LIFE. MOST HOMEOWNERS MADE THE DECISION TO BUY A HOME -- THE SINGLE BIGGEST FINANCIAL COMMITMENT THEY WILL EVER MAKE -- BASED ON THE KNOWLEDGE THAT THEIR PROPERTY TAXES WOULD BE DEDUCTIBLE. IN LITERALLY MILLIONS OF CASES, THE PRESIDENT'S PROPOSAL WOULD SEVERELY DISRUPT INDIVIDUAL FAMILIES' PERSONAL FINANCIAL PLANS.

DEDUCTIBILITY OF STATE AND LOCAL TAXES OFTEN IS PERCEIVED AS PROVIDING A TAX BENEFIT TO UPPER INCOME TAXPAYERS. TO VIEW IT IN THAT LIGHT OVERLOOKS THE FACT THAT REPEAL OF THIS DEDUCTION WOULD INCREASE THE TAX LIABILITY OF MANY LOW AND MIDDLE INCOME TAXPAYERS. THERE ARE ALMOST AS MANY HOMEOWNERS AS RENTERS WITH INCOMES BELOW $10,000, AND THERE ARE SUBSTANTIALLY MORE HOMEOWNERS THAN RENTERS WITH INCOMES BETWEEN $10,000 AND $20,000. MANY LOW INCOME HOMEOWNERS ARE ELDERLY AND ON FIXED INCOMES. ONE-HALF OF THE HOUSEHOLDS MAKING BETWEEN $20,000 AND $25,000 A YEAR DEDUCT STATE AND LOCAL TAXES, AND TWO-THIRDS OF ALL HOUSEHOLDS WITH INCOMES BETWEEN $25,000 AND $30,000 USE THIS DEDUCTION. MANY WHO HAVE JUST MANAGED TO FIT THE COST OF HOME OWNERSHIP WITHIN THEIR FAMILY BUDGET, WILL NOW FIND THEY ARE UNABLE TO DO SO. COUNTLESS OTHER FAMILIES AND YOUNG COUPLES HOPING TO BE ABLE TO AFFORD A FIRST HOME WILL FIND THEMSELVES HOPELESSLY PRICED OUT OF THE MARKET. MANY SENIOR CITIZENS FOR WHOM THE PROPERTY TAX IS THE LARGEST PART OF THEIR MONTHLY COST OF HOME OWNERSHIP, WILL NOW FIND THEY SIMPLY CANNOT MAKE ENDS MEET. FOR THESE TAXPAYERS, LOSS OF THIS DEDUCTION WOULD MAKE PROPERTY TAXES MORE REGRESSIVE AND THEREFORE MORE ONEROUS.

SUMMARY:

MR. CHAIRMAN, I WOULD LIKE TO SAY, ON BEHALF OF NACo AND COUNTIES ACROSS THE COUNTRY, THAT WE HAVE SUPPORTED THE PRESIDENT AND THIS CONGRESS IN THEIR APPROACH TO NEW FEDERALISM. WE HAVE SUPPORTED CUTS IN CERTAIN FEDERAL DOMESTIC ASSISTANCE PROGRAMS, AND WE HAVE ALWAYS BELIEVED IN LOCAL RESPONSIBILITY. BUT, WITH RESPONSIBILITY, WE MUST HAVE FLEXIBILITY AND CONTROL -- WHEN LIMITS ARE IMPOSED FROM ABOVE, RATHER THAN FROM WITHIN, THE ABILITY TO MANAGE WELL BECOMES A DIFFICULT TASK. THIS IS NOT WHAT AMERICAN FEDERALISM IS ABOUT AND WE HOPE THAT THE PRESIDENT AND CONGRESS WILL NOT

BREAK FAITH WITH US BY ELIMINATING STATE/LOCAL DEDUCTIBILITY -- A HISTORICAL CORNERSTONE OF INTERGOVERNMENTAL RELATIONS.

IT IS IRONIC THAT OTHER PARTS OF THE PRESIDENT'S TAX PLAN RETAIN DIRECT TAX CREDIT -- WHICH ARE SIGNIFICANTLY MORE ADVANTAGEOUS THAN TAX DEDUCTIONS -- FOR FOREIGN TAXES PAID BY CORPORATIONS AND INDIVIDUALS. THIS BENEFIT COSTS THE FEDERAL GOVERNMENT OVER $22 BILLION A YEAR -- WITH THE BULK OF IT DUE TO CREDITS TAKEN BY OIL COMPANIES AND FINANCIAL INSTITUTIONS. IF THE PRESIDENT THINKS IT'S WORTHWHILE FOR PEOPLE TO BE ABLE TO DEDUCT THE COST OF TAXES THEY PAY TO FOREIGN GOVERNMENTS, WHY DO THEY WANT TO DEPRIVE OUR OWN STATE AND LOCAL GOVERNMENTS OF THE SAME BENEFIT? STATE AND LOCAL GOVERNMENTS ARE ONLY ASKING TO BE TREATED WITH AS MUCH CONSIDERATION AS SAUDI ARABIA, SWITZERLAND AND KUWAIT.

THANK YOU. I WOULD BE PLEASED TO ANSWER ANY QUESTIONS AT THIS TIME.

STATEMENT
OF
JOSEPH LEAFE, MAYOR OF NORFOLK, VIRGINIA
FOR THE
NATIONAL LEAGUE OF CITIES

JUNE 26, 1985

Good morning, Mr. Chairman and members of the subcommittee, my name is Joseph Leafe. I am the Mayor of Norfolk, Virginia and I serve as the vice-chair of the Finance, Administration and Intergovernmental Relations Committee of the National League of Cities, the oldest and largest organization representing municipalities in the country. I am testifying this afternoon on behalf of the 15,000 direct and indirect members of our organization.

I am here to testify on an issue of great concern to city officials. At our Congressional-City Conference this March, our Board of Directors determined that maintaining the deductibility of state and local taxes from the federal individual income tax is essential to enable cities to continue to provide necessary services and to comply with federal mandates.

As you know Mr. Chairman, 1985 marks a year when cities will be asked to assume major new, unfunded responsibilities. It is a year in which both direct and indirect federal assistance are going to be cut sharply. The Congress has proposed to eliminate our single most important program to help respond to fiscal distress, General Revenue Sharing. It has proposed cuts in almost all other direct assistance programs. The administration and Senate, in addition, have proposed deep cuts in indirect assistance. By that I mean they have proposed cuts in Medicaid, child nutrition, and other programs targeted to low income Americans. The citizens of Norfolk, through their local property tax and state income tax are paying for many of these support-type services. Because cities are the level of government of last resort for those who are hungry, homeless, or in need of urgent medical assistance; these are human mandates we will have to assume. They are unfunded liabilities.

In effect, one could say that the Congress has accepted a version of the original administration federalism proposal, that is cutting off most federal assistance and turning over a host of responsibilities to state and local governments.

However, there is one enormous and disturbing difference: as originally proposed, the new federalism proposal recognized the extraordinary cost burdens it would impose on state and local governments. Consequently, the original administration proposal advocated turning back a number of revenue sources to cities and states to pay for these heretofore federal responsibilities. Now, this time, that part of the proposal is not only absent, but in its place has been substituted a proposal which will make it harder for us to raise our own taxes. It would be counterproductive to remove the state and local tax incentive that is built into the reduction of state and local taxes from federal income considerations.

In the desire to find sources of revenue with which to lower the tax rates, the Treasury has linked the deductibility of state and local taxes--claiming that tax reform itself is impossible without repeal. The Treasury has not distinguished either the historical role of deductibility or its existence in the Constitution and Internal Revenue Code, not as a tax shelter, but as an integral part of our federal system. It has not distinguished, as you pointed out to the Secretary, Mr. Chairman, how it can propose to eliminate deductibility as a special preference while retaining the mortgage interest deduction, charitable contributions, and special breaks for the oil and gas industry.

Mr. Chairman, our organization has devoted more than two years developing national municipal policy on tax reform. We support reform. But nowhere in our policy is there a statement that the single most important goal and objective of tax reform is a wholesale reduction of rates. Our policy is very specific, however, in saying:

> "Reforms to the federal tax system must acknowledge the direct and indirect linkages between federal and local tax systems. Changes to the federal tax system that reduce the ability of cities to raise

revenues and capital must be accompanied by specific federal actions to address any adverse impacts."

You, Mr. Chairman, are unique in the Congress from the perspective of the policy concern in that you have submitted such a proposal.

The deductibility of state and local taxes has been a part of the U.S. income tax system since the system's inception in 1913. Moreover, the concept of reciprocity has been an ingredient of Federalism in our Constitution. In large part, reciprocity has been the cornerstone of our federal system.

Just as cities, who are prohibited from imposing property taxes on federal land, a major portion of Norfolk's land base is owned by the Federal Government -- even though we must provide the same level of services as we do to all other property owners within our cities--and just as we are prohibited from treating the interest earned on federal securities as income for tax purposes, so too the federal government has not in the past proposed to impose a tax on our taxes or on our securities backed with our taxing power's full faith and credit. Whether this is called comity or federalism, the point is the same, our system of government is intended to be mutually reinforcing, not predatory and preemptive.

To be honest, Mr. Chairman, we are confused by a proposal which has the appearance of setting a double standard. That is, it seems to say that it is all right for the federal government to deduct its $13 million worth of property tax liabilities to Los Angeles, but it is not o.k. for property taxpayers in Los Angeles to deduct their property taxes from their federal income taxes.

While the tax reform proposal would partially compensate some individual taxpayers for the loss of the ability to deduct state and local tax payments from federal income tax liability by lowering marginal tax rates, state and local governments would not be similarly compensated. Thus the President's tax reform proposal appears to set a double standard and ignores the constitutional protection and taxing authority granted to cities. The elimination of the state and local tax deduction could be seen in direct conflict with the principles of federalism and reciprocal immunity. In essence, the elimination would severely affect the cities' abilities to provide services, especially the ability to implement the many federally mandated programs, including medicaid, nutrition, and services to the homeless which account for much of the current high levels of taxation, especially in inner cities.

For it is in its elimination of state and local tax deductibility that the tax reform proposal is least sympathetic to areas with high service demands. As the Federal government curtails funding for services, cities must provide the safety net. We provide the 9-1-1 service. Not only must we provide the net, but we are compelled to provide it through our own tax revenues. Central cities in urban states must provide the safety net for the most dependent of our citizens who have been left isolated by urban flight. These cities are faced with high levels of service demand caused by such factors as the high numbers of foreign immigrants who must be provided with services to assist their integration into the American social and economic system. These cities, in particular, must respond to the high levels of overcrowded, antiquated and inadequate housing and the high numbers of impoverished households headed by females with dependent children. Not only do these cities have to pay for significantly higher service costs per capita, but they have a more limited revenue base from which to draw.

The concept, suggested by one of your colleagues, that the repeal of deductibility should be phased in so that every state and local government would have time to reduce taxes to a national lowest common denominator is simply absurd. As you so eloquently addressed our membership in Detroit in 1981, Mr. Chairman, there is no common denominator of need in the nation. The idea that federal policy should be a club to drive down state and local taxes according to some policy set by the federal government is antithetical to our political system. It appears to spring from the concept that taxing and spending are not necessarily related.

While it is estimated that the loss of deductibility would cause state and local government revenues to fall by $12.4 billion directly, there are other side effects in addition. All cities issue general obligation bonds for the construction and operation of municipal infrastructure. These bonds are backed by our taxing authority. Yet, as this taxing authority is adversely impacted by this tax proposal to discourage and disadvantage state and local taxes, it will lower bond ratings, and increase our cost of borrowing.

Although it is difficult to quantify the impact of the repeal of deductibility on a city by city basis, we are especially concerned that cities would lose jobs and taxpayers to lower tax suburbs. Cities tend to provide a disproportionate amount of services--requiring higher taxes--not only because they must serve non-residents during working hours, but also because they tend to have disproportionately higher levels of persons in need. The economic base of the higher tax cities would be weakened. As these cities lose their own capacity to finance essential social services, the needy and the poor will suffer. The cycle will become more vicious. As the federal government continues to transfer to cities the responsibility of programs to aid the poor and needy and as the Congress puts together a budget package that would in essence leave cities alone with the growing fiscal responsibility for education, housing, infrastructure, health care and other programs, it seems like a double whammy that the tax reform proposal--instead of helping cities meet their own revenue needs to assume federal responsibilities and replace federal assistance--appears to penalize the cities of this nation for struggling to meet their own needs through responsible and necessary revenue measures by eliminating deductibility.

In our view, Mr. Chairman, you are one of the only members to recognize the unfairness of the administration's proposal and to attempt to address in a manner consistent with our federal system. That is to say, if deductibility is somehow an inappropriate or unfair federal policy as it affects state and local governments, then Congressional action should be to address to perceived inequities. You have suggested that because deductibility is related to fiscal needs and capacity, it ought to be related to its natural counterpart, revenue sharing. We concur.

Wednesday
26 June 1985
Washington, D.C.

Testimony for U. S. Senate Subcommittee on Intergovernmental Relations

by Martha Lee (Marti) Zins President
Minnesota Education Association

Mr. Chairman and Members of the Subcommittee, my name is Martha Lee (Marti) Zins. I am a teacher in the Hopkins, Minnesota school district - currently on leave to serve as President of the Minnesota Education Association, an affiliate of the National Education Association. As such, I am greatly concerned by the recommendation of the current administration to tax our state and local taxes, the overwhelming source of education revenue.

In Minnesota, we are justifiably proud of our strong education system. The historical commitment on the part of Minnesotans enables our state to be a leader in educating all. Minnesota, for example, has - consistently - had a high retention rate, currently at 91 percent.

But - it is becoming more and more difficult to keep that level of commitment.

For instance, fewer than one in five of the households in Minnesota have school-age children.

For instance, our rural economy is in a life-or-death struggle. And passing of local property tax levy referenda for education is no better than a 50-50 proposition - be it metro or rural.

- more -

Now, if we eliminate the deductability of local taxes - to begin taxing a tax - the chances of passing local school referenda virtually will be eliminated.

This proposal comes as "experts" in Washington - and St. Paul - are telling us we have to improve education.

I ask you to visit with teachers from each of your states - so you can understand better the grave potential for harm to our public schools that will result from the elimination of deductability of state and local taxes.

The potential damage of this proposal would touch every state and every classroom in every state.

This makes teachers mad!

Because our historical commitment to public education helps make us a high tax state, Minnesota would be one of the hardest hit states under this proposal.

According to a study released by Senator Moynihan of New York, Minnesota could lose an estimated $671 per pupil of revenue. That's a lot of money!

We have just completed a difficult session of the Minnesota Legislature, followed by an even more difficult special session. Despite a billion-dollar surplus, we were able to increase per pupil spending by only a little more than $200 during the 1985-87 biennium.

- more -

The proposal you are considering cuts us back $671 per pupil.

This cannot be tolerated!

Public education needs your support now, more than ever!

From our point of view, elimination of the federal deduction for state and local taxes is one of the most critical issues this Congress will face.

One point repeated in nearly all of the reports about education is the need to raise teacher salaries, a goal with which we wholeheartedly concur.

But - if we continue to restrict the source of funds available to our public schools, not only this recommendation, but those affecting curriculum and students are worthless. Already, this administration has cut back on meager federal funds to education. Now, the administration is attacking our only other source - state and local taxes.

As the NEA gathers here in Washington this week for our annual Representative Assembly, some 200 Minnesotans will be discussing this issue with many of the other seven-thousand delegates.

In summary, passage of this so-called reform of our tax system:

- would jeopardize the fundamental support the people provide to our nation's schools - and the forty-million students being educated.

- more -

- would slash the resources available to states and local governments for education programs, as well as for a variety of essential social services.

- would devastate hopes for enhancing American education - and would cripple the educational reform now in progress.

- would translate as a tax hike - not a tax reform - for individuals and as a revenue loser for state and local governments - and would spell a clear disaster for American education.

Finally -

- this proposed tax reform would result in a form of double taxation: A tax on a tax.

In Minnesota, we care a lot about the future of education. I want to believe that feeling is shared nationwide.

Now is the time to enhance our investment in the schools of our nation - not to undermine their potential.

At stake is more - much more - than just dollars and cents!

What is at stake?

The opportunities we could provide our children and the future we could build for our nation.

Thank you.

- more -

Senator **Durenberger**. Our final two witnesses are Dennis Zimmerman, a noted economist for the Congressional Research Service, and Dr. William Oakland, Chairman of the Economics Department at Tulane.

Who came from Tulane?

Mr. **Oakland**. I did.

Senator **Durenberger**. Why don't you go first?

Dennis, I take it you live in town so we can get you back here if we have to?

Mr. **Zimmerman**. Correct.

Senator **Durenberger**. I am running out of time. I regret having to say that if you have been sitting here for some length of time, but your full statements will be made a part of the record, and Dr. Oakland, you may proceed with your summary.

TESTIMONY OF PROF. WILLIAM OAKLAND, CHAIRMAN DEPARTMENT OF ECONOMICS, TULANE UNIVERSITY; AND DENNIS ZIMMERMAN, ECONOMIST, CONGRESSIONAL RESEARCH SERVICE

Mr. **Oakland**. My name is William Oakland. I am a professor of economics at Tulane. My speciality is in public finance, particularly as it relates to State and local governments. In this connection, I recently completed a study for the U.S. Treasury on the consequences of the repeal of State and local tax deductibility under the Federal income tax. I appreciate the opportunity to be here today to discuss the principal findings of the study.

The consequences of tax deductibility are many, complex and far-reaching. It is unlikely that many of these effects were foreseen by framers of U.S. income tax law, nor that they had all been considered by those who advocate tax reform. Let me begin with a brief summary of these consequences. The details supporting my arguments can be provided during the question period, if we have one, or in my Treasury paper, which I am submitting for the record.

Senator **Durenberger**. It will be made part of the record.[1]

Mr. **Oakland**. First and most important, the fairness case for total repeal of tax deductibility is far from compelling. It is true that a comprehensive income tax would include, in it its base, the benefits that one receives from public services.

However, it is much less certain that these benefits are accurately measured by an individual's tax payments, and that is essentially the logic of the reform proposal, that the benefits one receives from State and local services are measured by one's payments to the State and local governments. I don't believe that that is an accurate measurement. Taxes may vary among two individuals residing in different States or localities, not only because of differences in services that they receive, but also because of differences in the costs of others' public services that they pay for.

For example, the cost of welfare and welfare-related services will be higher in States with more generous benefits, as in Minnesota, or with greater incidence of poverty, as in Louisiana. In neither case could it be said that the higher tax payments represent an increase of public services to the taxpayer.

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[1] See p. 159.

It is also true that areas with high concentrations of poor, such as central cities, must impose a heavier tax burden on their nonpoor to pay for ordinary public services such as police and education. Here again, the higher taxes cannot be said to constitute income to the taxpayer.

Now another reason why taxes, personal taxes, in particular, can vary among States is the existence of natural resource deposits or some natural geographic advantage which attract businesses. Each of these enables some States to enjoy the same or higher levels of public services with lower personal tax payments.

So residents of Alaska, for example, enjoy public services four times the national average yet only pay an average amount of personal taxes that are deductible. The repeal of deductibility does nothing to tax supernormal Government benefits. Rather, it puts States with less natural endowment at an even greater competitive disadvantage with those that do have these advantages, for example, Louisiana, which derives about 35 percent of its revenues from taxation of minerals.

Second, it is not true, as some critics have held, that tax deductibility is a less efficient means of aiding State and local governments. I know that subject came up earlier in the discussion. I happen to disagree with that assessment.

For example, it is said that it has less effect than revenue sharing or block grants in stimulating local government expenditure. Because it operates in a fashion akin to an open-ended matching grants, tax deductibility may offer a more powerful stimulus to State and local governments than these alternatives, that is, revenue sharing and block grants. To provide the same degree of stimulus as tax deductibility, Federal block grants would have to be increased by an amount greater than the amount of tax foregone under present arrangements. Thus, if the Federal Government is interested in maintaining current Government spending, it will have to increase its budget deficit. Of course, if the intention is to curtail such spending, as some suspect, repeal of deductibility will prove very effective, for it will raise the price to citizens of supporting new and existing public expenditures.

I can find no reason why State and local spending would be reduced. Indeed, the cards already seem to be stacked against the ability of State and local governments to meet their responsibilities.

Third, State and local governments may respond to the repeal of personal tax deductions by redirecting their tax systems towards business establishments, whose taxes remain deductible. Sometimes, such changes would be fundamentally cosmetic, not really having any major impact in terms of the incidence of the tax. For example, a state could replace its personal income tax by a value-added tax. I think Minnesota considered that.

A value-added tax would be deductible and would have essentially the same incidence as a similar personal income tax. That would enable the State to continue to explore its tax burden to the Federal Government. However, in many cases, these would not be so cosmetic, and we would impose taxes on business and the incidence of these taxes are difficult and their consequences are highly uncertain.

So that I think we might really encourage some really perverse actions on a State and local level. I guess I am out of time, so I will leave the remainder of my statement to be put in the record, but I did make my major points. Thank you

Senator **Durenberger**. You did, and I did take the time ahead of time to read your personal statements. I appreciate it very much. I just wish more folks were here to hear it.

Dr. Zimmerman, go ahead and summarize your statement.

Mr. **Zimmerman**. Mr. Chairman, thank you for the invitation to appear before you today. I wish to emphasize three points from the written statement I am submitting for the hearing record.

First, the economic rationales for deductibility. Deductibility is not well justified by one of the economic rationales usually cited in its support. The double tax or "don't tax a tax" argument implies a view of taxes as mandatory payments for which taxpayers receive no compensating benefits. This "coercive" view of government seems inconsistent with our civics lesson on representative government. Some would argue that payments for the benefits of State-local goods should no more be deducted from Federal taxable income than should payments for furniture or ice cream cones.

There is considerably more merit to the argument that some State-local goods provide social benefits that spill over political boundaries and that these social benefits will be underprovided without the stimulation provided by Federal subsidy. One may quibble over the share of the State-local budget which merits or does not merit subsidy, but few would contend the Federal responsibility is zero. The problem is that the deductibility provision does not distinguish very well between those State-local goods which merit and those which do not merit subsidy. It is the Federal grant system, not the Federal tax system, which is well-suited to the task of providing subsidies selectively.

My second point relates to the interaction of tax and intergovernmental policy.

A decision on eliminating deductibility should consider explicitly how the revenue gain is to be divided between Federal tax rate reduction and better-targeted Federal grants. If one suspects that in the current fiscal environment the subsidy for deserving State-local expenditures that is currently provided by deductibility would not be replaced by a better-targeted Federal grant, then it might be desirable to consider a middle ground between totally eliminating the deduction and the status quo.

The options seem to be a floor, a ceiling, or a selective elimination of particular taxes, as in the Bradley-Gephardt and Kemp-Kasten proposals. The floor seems to have several advantages over the alternatives.

First, it conveys the message that the amount of taxes up to the floor is considered normal or reasonable and that no subsidy is deserved for these typical amounts of public consumption. Only extraordinary amounts above this floor are to be subsidized. This is an appealing option if all such high spending were related to concentrations of the poor and otherwise needy persons.

Second, if the floor is set below the tax burden in the lowest tax State, the tax price would not be changed, and the negative impact on State-local revenues would be minimal.

Third, a floor might distribute the increased Federal tax burden more evenly among the states.

And fourth, a floor would not affect the choice among State-local tax sources as would elimination of selected taxes in the Bradley-Gephardt and Kemp-Kasten proposals.

One estimate of a 1-percent floor suggests that it would cost the Treasury about 56.2 percent of the revenue gain it expected from eliminating deductibility in the Treasury I proposal.

My final point relates to the effect on State-local taxes and spending. Much concern has been expressed over the effect on State-local taxes and spending. Eliminating deductibility raises the tax price itemizers must pay for State-local goods and services, but does not change the tax price for nonitemizers. The effect on taxes and spending will vary substantially among communities. Elimination of deductibility in a suburban bedroom community school district of itemizing homeowners with revenues almost entirely raised via property taxes can be expected to reduce property tax revenues and, consequently, spending on education by about 12.8 percent.

In a big city, where nonitemizing renters are more likely to exercise joint political control with itemizers and numerous business tax revenues and Federal grants are received, the reduction in all spending might be less than 1 percent. Of course, it is possible that higher income residents might move out of the city, which would cause spending to further decline.

That concludes my oral statement. Thank you.

Senator **Durenberger**. And I thank you. I imagine these are the two only two apolitical statements we have. That is presuming on your qualifications, your background and everything else.

I am grateful to you both for your contributions, and if you don't mind, we will be continuing to draw on your expertise and your insight, at least through this committee, which has, as its goal, the strengthening of the Federal system and the various tools that might be available to us.

I thank you again for being here and for taking the time to give us your presentations. We will be submitting written questions to you for the record.

[Mr. Oakland's prepared statement and Mr. Zimmerman's responses to questions follow:]

Testimony of William H. Oakland

Before the Senate Subcomittee on Intergovernmental Relations

June 26, 1985

My name is William Oakland. I'm a professor of Economics at Tulane. My specialty is public finance, particularly as it relates to state and local governments. In this connection, I recently completed a study for the U.S. Treasury on the consequences of the repeal of state and local tax deductibility under the federal personal income tax. I appreciate the opportunity to be here today to discuss my principal findings.

The consequences of tax deductibility are many, complex, and far reaching. It is unlikely that many of these effects were foreseen by framers of U.S. Income Tax Law, nor have they all been considered by those who advocate reform. Let me begin with a brief summary of these consequences. The details supporting my arguments can be provided during the question period as well as in my Treasury paper which I am submitting for the record.

First, and most important, the equity case for total repeal of tax deductibility is far from compelling. It is true that a comprehensive income tax would include, as income, benefits one receives from public services. It is much less certain that such benefits are accurately measured by tax payments, as our reformers would have us believe. Taxes may vary among two individuals residing in different states not only because of differences in public services each receives, but also because of differences in the costs of others' public services each absorbs. For example, the costs of welfare and related services will be higher in states with more generous benefits or with a greater incidence of poverty. In neither case could it be said that the higher tax payment represents an increase in public services to the taxpayer.

It is also true that areas with high concentrations of poor, such as central cities, must impose a heavier tax burden on their non-poor for ordinary public services such as education or police. Here again the higher taxes cannot be said to constitute income to the taxpayer. Another reason why personal taxes can vary among states is the existence of natural resources deposits or natural geographic advantages which attract business. Each of these enables some states to enjoy the same on higher levels of public services with lower personal tax payments. Thus, residents of Alaska enjoy public services four times the national average yet their personal tax burdens stand near the national average. Repeal of deductibility does nothing to tax these supernormal government benefits. Rather it puts states with less natural endowment at an even greater competitive disadvantage. For all of these reasons it is difficult to believe that repeal of deductibility will improve the fairness of our income tax.

Second, it is not true, as some critics have held, that tax deductibility is a less efficient means of aiding state and local governments than Revenue Sharing or Block Grants. Indeed, because it operates in a fashion akin to open-ended matching grants, tax deductibility may offer a more powerful stimulus to state and local government spending than these alternatives. To provide the same degree of stimulus as tax deductibility, federal block grants would have to be increased by an amount greater than the tax foregone under present arrangements. Thus, if the Federal Government is interested in maintaining current state-local spending, it will have to increase its budget deficit. Of course, if the intention is to curtail such spending, repeal of deductibility will prove very effective. For it will raise the price to citizens of supporting new and existing public expenditures. But, I can find no reason why state and local spending should be reduced. Indeed, the cards already seem to be stacked against the ability of state and local jurisdictions to meet their responsibilities.

Third, state and local governments may respond to the repeal of personal tax deductions by redirecting their tax systems towards business establishments whose taxes remain deductible. Sometimes the changes would be cosmetic, not fundamentally changing the nature and incidence of taxes. For example, a state could replace its personal income tax by a tax on value-added or payroll. Such a reform would enable the state to continue exporting taxes to the Federal Government without a major redistribution of the tax burden.

Such cosmetic opportunities are apt to be quite limited. Hence, many states and localities will respond by making a substantive shift to business taxation. Because the incidence of business taxes is often difficult to establish, the consequences for equity are highly uncertain. Furthermore, the increased reliance on business taxation could lead to heightened tax competition among states. This would adversely affect the growth of state and local public services. These reactions will be difficult to avoid. For it is unthinkable that the present deduction of business taxes would be disallowed.

While these constitute the major consequences of repeal, there a few other effects worth mentioning. Repeal will not uniformly favor the poor taxpayer relative to the rich. In high expenditure states, the poor will experience a reduction in redistributive services as these governments respond to the reduced subsidy from the federal government. Moreover, such people will also experience increases in housing costs as the effective rate of the property tax is increased. Affluent residents of low tax states, on the other hand, will experience lower housing costs. Finally, for reasons too technical to go into here, it is not even clear that the incentive and productivity improvements that are supposed to accompany tax simplification will materialize if deductibility is repealed.

To reiterate, the consequences of the repeal of tax deductibility are many and complex. The case for their removal are not as compelling as advocates of tax reform would have us believe. Perhaps partial repeal, by placing a floor on deductible tax payments, should be considered. This would maintain many of the incentives of present arrangements while still providing significant revenue for rate reduction. Moreover, it would be consistent with the reality that all taxpayers enjoy the benefits of some public services.

RESPONSES TO WRITTEN QUESTIONS FROM SENATOR DURENBERGER

Question 1. In your testimony, you suggested that deductibility is not defensible on economic grounds. Yet you suggest that deductibility should not be eliminated, but rather should be limited with a floor or some other partial approach. Would you explain your reasoning for this conclusion.

Answer. In a world where we were going to completely restructure the system of Federal support for State-local activities which merit subsidy due to spillover effects, it would probably be desirable to dispense with deductibility in favor of better-targeted grants. The debate would then be over the extent to which the revenue gain from eliminating deductibility is to be divided between Federal tax rate reduction and better-targeted Federal grants. That is not the environment in which deductibility is now being considered. Rather the environment is one in which Federal grants to the State-local sector have been continuously cut back for the last four years. Given the absence of intergovernmental policy considerations in the debate, intergovernmental policy may best be served not by eliminating the subsidy, since we know some State-local activities are deserving of subsidy, but rather by reducing the subsidy, since we know some State-local activities do not deserve subsidy.

Question 2. If the deduction of state and local taxes was eliminated, what would be the consequences for state-local spending? How would the consequences vary among different types of jurisdictions? How would programs for low-income individuals be affected?

Answer. Spending can be expected to decline because the major economic factor which affects spending decisions is altered by the elimination of deductibility. This factor is the cost to the taxpayer of a dollar of State-local tax payment. With deductibility, the after Federal tax cost to the taxpayer is one minus the taxpayer's Federal marginal tax rate. After deductibility is eliminated, the cost is one dollar. This increase in what has been referred to as the "tax price" can be expected to cause the taxpayer to reduce his demand for the now relatively more expensive State-local goods and services, which of course means a reduced willingness to pay State-local taxes.

The effect will vary among communities depending upon the size of the price subsidy from deductibility (determined by itemizers' marginal tax rates), the share of the population that itemized taxes, how influential these itemizers are in controlling the State-local political process, and the share of all revenues raised via deductible taxes. These factors vary substantially among types of communities. In a suburban bedroom community school district of all homeowners who itemize, in which almost all revenues are raised by the deductible property tax, revenues and expenditures can be expected to decline by about 13 percent. In a big city where nonitemizing renters are more likely to exercise joint political control with itemizers and numerous business tax revenues and Federal grants (which were not deductible and therefore experience no price change) are received, the reduction in all spending might be less than 1 percent.

The effect on low-income programs is hard to determine. To the extent these programs are concentrated in jurisdictions like the big city example cited above, the effect would not be that great. But one would need to know how these various jurisdictions make their marginal budgetary decisions. It is possible they could concentrate their cuts on low-income programs.

Question 3. Should the Congress move toward a limitation proposal, interest will grow in the relative merits of alternative proposals. Would you comment on the major alternatives, such as a floor, a ceiling, selective elimination as in Bradley-Gephardt and Kemp-Kasten, and a tax credit such as the 14 percent rate for allowed deductions in Bradley-Gephardt.

Answer. First, selective elimination of particular taxes creates problems not experienced with the alternatives. It would cause State and local governments to alter their tax structures away from the tax losing its deductibility status toward those taxes which continue to be deductible. Not only would this interfere with State-local choice of tax sources, but the Federal revenue gain would be seriously reduced as tax structures are altered to maintain maximum deductibility. In addition, the increased Federal tax burden would be very unevenly spread among the States, as those States not using (or not heavily using) the disallowed tax experience no increased Federal tax liability.

A floor of ceiling as a percent of AGI would not affect State-local choice among tax sources. The ceiling would probably have a greater adverse impact on State-local revenues than would a floor, because it is more likely to affect the taxpayer's tax price. If the floor is set below the tax burden in the lowest tax state, the tax price would not be changed and the negative impact on State-local revenues would be minimal. A floor also conveys the message that the amount of taxes up to the floor is considered normal or reasonable, and that no subsidy is deserved for these typical amounts of public consumption. Only extraordinary amounts above this floor are to be subsidized. Finally, a floor might distribute the increased Federal tax burden more evenly among the States than either a ceiling or selective elimination.

The credit approach could be combined with any of these alternatives. It would satisfy the criticism that the deduction is worth more per dollar of State-local tax to higher income taxpayers.

Senator DURENBERGER. Thank you very much. The hearing is adjourned.

[Whereupon, at 4:10 p.m., the subcommittee was recessed, subject to the call of the Chair.]

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

NSBA
NATIONAL SCHOOL BOARDS ASSOCIATION
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(703) 838-NSBA

My name is Joan Parent, and I am a local school board member from Foley, Minnesota and a former President of the National School Boards Association. The National School Boards Association is extremely concerned over the practical impact which the Administration's proposal will have on both local and state derived revenue sources for education. Those effects will vary from state to state depending upon: a) how revenues are raised, and b) the economic and political realities which confront local and state policy-makers.

With respect to local funding in many states such as Oregon, Ohio, Wisconsin, New Jersey, and my own Minnesota, where a local tax levy, excess levy, or the local school budget is presented to the voters for approval, the impact will be especially severe. The problem is compounded by timing. For the most part, these local votes occur in the Spring — right before or after our local tax voters file their April 15 federal tax returns. My judgement is that when substantial numbers of taxpayers find themselves paying $700, $900, or over $1,000 more in federal taxes — they will react negatively at the local polls on April 1, May 1, or June 1. We experienced this situation in Minnesota, following the imposition of a state surtax, in 1981, when local tax levy approval rates fell to 53% from 77% in the previous year. Since then the economy has improved and state surtax has been removed — and local approvals are back up to 79%. We are concerned that increasing federal taxes for those people who tend to vote on local issues, will have the same negative impact.

I am also concerned about those cases in which local boards set tax levies and budgets without formal submission to the voters. As elected and accessible community leaders, school board members will be responsive to demands for tax relief by those who would be paying more. If anyone doubts the impact which opponents to local tax increases can have, they need only attend a local school board meeting during the budget season. Likewise, fiscally dependent districts will also feel the impact as they seek funding from county and city officials — who themselves are under taxpayer pressure. On this point of dependent districts, we have a special concern in those situations in which the school board is elected, to deal with education, and the city and county government — which holds the purse strings — is elected to deal with other public services. Given the pressure which will be on city and county government to hold taxes down, and especially since education tends to be the largest line item, funding for education will be vunerable as city and county officials seek to fund their immediate areas of responsibility first. We are also concerned over the impact which this proposal will have on the passage of local school bond issues — as well as on the potential bond rating for school districts whose revenue picture is radically altered by the proposal. This impact on school bond interest rates will be compounded by the Administration's proposal to lower of tax rates -- which in itself will make tax exempt bonds less attractive.

Who are the people who itemize? They include single homeowners, married homeowners without children, and homeowners with children in private schools. We suspect in most communities that, among people who itemize, most do not have children in the local public schools. In the face of increased federal taxes, how strong a sacrifice are we now asking them to incur for their continued support of local tax dollars for education? It is estimated that the Administration's proposal is the equivalent of a 40% local property tax increase. In viewing full state and local deductibility, one does not increase $30 billion of tax payer obligation and believe nothing will happen.

In addition to the local property base, other impacts of this proposal should be examined as well. For example, as federal dollars diminish, the very existence of smaller state programs unrelated to education are bound to be funded at the expense of the state's largest line item — public education. For those states seeking increases to their state income tax; they are bound to meet with resistance from federal tax payers who would lose this deduction. In Nebraska last year, a petition for a Proposition 13 type of referendum failed to be put on the ballot by a mere 3,000 signatures. School boards in Nebraska believe there will be a Proposition 13 on their ballot next year if this state and local deductibility is lost.

Apart from the negative impact which this proposal will have on public education, a number of other policy implications should be examined as well.

- Locally and state provided services are in the national interest and should be encouraged. This provision will have the immediate impact of effectively imposing a 40% tax on providing services at current levels.

- It is simplistic to say that taxpayers in states which do not have high state and local taxes are subsidizing those people who pay higher taxes in other states. To a great measure, people who itemize do not participate in many of those public services targeted to lower income groups.

- It is also simplistic to view the devastating impact which the loss of this deduction will have on local and state revenue raising capacity out of context with other proposals which will further increase federal taxpayer obligations. For example, reinstatement of the marriage penalty and altering the child care credit -- heaped on top of the loss of the state and local deduction will hurt local taxpayers — and their ability to support education.

- Similarily, local economic conditions have to be taken into account. For example, in Oregon other proposed changes in the tax code will hurt the timber and vacation home industries upon which many of local communities are reliant. Coupled with a relatively higher personal income tax obligation, we foresee major problems at the local level.

- This proposal is inconsistent with the policies and obligations incurred by local government to attract industry — and the expanded tax base which they hope to bring to a community — through the improvement of public services, such as education. Those efforts to attract community growth through improved public services will now become a penalty in some communities.

- The proposal is bound to have an impact not only on the public's attitude toward financing services, but the mechanisms which are utilized. For example, the loss of deductibility discourages the progressive state income tax.

Conclusion

Overall, the federal government can support the public service efforts of local and state government through: a) general revenue sharing and block grants; b) categorical assistance, and c) the tax code. The first two areas have been reduced in recent years, and, now, the third area is being slated for elimination. The combined impact is potentially devastating. In cash value, the cost of deductibility to education is roughly equal to the entire budget of the federal Department of Education. Deductibility is unique because, as a federal subsidy, it is pure local control -- with no strings attached. Congress should not undertake to surrender or even compromise this vital asset.

TESTIMONY FOR THE RECORD

FROM

THE HONORABLE ED HERSCHLER

GOVERNOR OF WYOMING

HEARING BEFORE

THE SENATE SUBCOMMITTEE ON INTERGOVERNMENTAL RELATIONS

COMMITTEE ON GOVERNMENTAL AFFAIRS

REGARDING

DEDUCTIBILITY OF STATE AND LOCAL TAXES

June 26, 1985
Dirksen Senate Office Building
Washington, D. C.

I am pleased to submit this statement for the record of the hearing held June 26, 1985, by the Senate Subcommittee on Intergovernmental Relations concerning the federal income tax deduction for state and local taxes. My statement will reflect a fundamental belief that federal policies should avoid influencing state decisions regarding the manner in which states finance and structure delivery of the governmental services which their citizens require.

As Chief Justice Marshall recognized, the states' "power of taxation is indispensable to their existence." Any efforts to limit or influence this power should be treated as a matter of the greatest delicacy. Unfortunately, in the case of federal income tax reform, delicacy has been pushed aside in the rush to achieve other goals. I am hopeful that this committee can interject some delicacy back into these deliberations on tax reform.

Death and taxes, the two certainties of life, have challenged modern man's basic philosophical beliefs for centuries. The proposed federal income tax reform leads us again to philosophical dialogue and debate. While analysts may attempt to characterize the tax reform debate through charts, graphs and tables, the outcome will likely turn on philosophical beliefs and convictions rather than numbers.

Factors such as state sovereignty, fiscal federalism, equity and national security do not easily lend themselves to economic modeling and standardized indices. Nevertheless, they are the basic beliefs and principles that have bound this nation of ours together, with results that are the envy of the world. In today's uncertain economic times, it would be foolhardy to abandon these principles in pursuit of new goals which are framed more by rhetoric than careful and considered analysis.

In a nation which often seems preoccupied with identifying winners and losers, it may seem strange that the governor of a state with relatively low overall taxes would rise in support of retaining the federal income tax deduction for state and local taxes. However, I see more at stake than numbers from the various taxing jurisdictions. The proposed elimination of deductibility threatens to weaken our federation of states, which is the foundation of our nation.

I have seen this threat first hand in a different, but related context, and have often defended Wyoming's state and local taxing decisions from threats of federal interference and pre-emption. In that context, Congress was reluctant to alter the historic and necessary rights of states to formulate their own taxing policies. I am hopeful that a similar reluctance will surface in the debates on the state and local tax deductibility issue. I am also hopeful that Congress will see certain transparencies in the logic which attempts to support eliminating deductibility of state and local taxes.

I find it interesting that the President's tax reform proposal would retain a "limited number of special deductions and exclusions -- principally those that are widely used and generally judged to be central to American values." The numbers I have seen indicate that the state and local tax deductions are among the most widely used of all deductions. In 1982, over 33 million taxpayers claimed the state and local tax deduction while 24.5 million or 25 percent less claimed the home mortgage interest deduction.

Moreover, it appears that use of the state/local tax deduction is particularly widespread among America's middle class. Eighty-seven percent of the returns itemizing state/local tax deductions come from taxpayers with incomes less than $50,000. The middle class are obviously significant users and beneficiaries of the current state/local tax deduction. While it is true that non-itemizers do not benefit from state/local tax deductions, this fact holds true for other deductions which are scheduled for retention under the President's proposal.

Finally, property tax deductibility, which is used by over 85 percent of all taxpayers itemizing state/local taxes, also supports America's unequivocal commitment to private-home ownership. State and local tax deductibility is obviously not a "loophole" that benefits a privileged few. Further, deductibility of state and local taxes is probably one of the simplest of all deductions because of the sales tax tables and the taxpayers ease in recording state and local property and income tax payments.

I have also heard the argument that this deduction somehow unreasonably "subsidizes" high tax states. Frankly, the logic supporting this argument escapes me. A taxpayer's total tax burden in a high taxing jurisdiction is still higher after the deduction, as compared to a taxpayer who benefits both from low state/local taxes and federal tax deductibility. A higher total tax burden doesn't seem to be much of a benefit or subsidy to me.

A major goal of the President's tax reform package is that the ultimate result be "revenue neutral". However, an equally important goal for tax reform should be jurisdictional neutrality. My experience with the divisiveness created by interstate and interregional tax battles, leads me to shy away from tax reform proposals which would fuel such no-win, state vs state confrontations. The potential for these battles and disunity is amplified today by the revenue problems facing state and local governments. Given the prior, significant cuts in federal aid to state and local governments, and the "New Federalism" push for increased state and local revenue responsibility, deductibility has become more important than ever in maintaining the fiscal health and perogatives of state and local taxing jurisdictions.

The need to maintain the fiscal health of state and local jurisdictions, buffer interstate tax differentials, preserve state sovereignty and taxing perogatives, and make federal tax policies more closely reflect "ability to pay" are all important principles that should be preserved under any tax reform. As with most principles, this preservation comes at a cost. However, in these troubled economic times, our nation needs unity. I believe the cost is one we can and must afford to pay.

It is my understanding that the proposal to eliminate state/local tax deductibility is characterized as essential to finance the proposed reduction in marginal tax rates. Perhaps the proposed rate reductions, particularly those benefiting the wealthiest taxpayers, deserve closer examination.

The effect of the non-deductible social security payroll tax on low and middle income taxpayers appears to be overlooked in the debate on appropriate marginal tax rates. Combining the social security tax with the President's proposed brackets makes the total federal tax burden rates approximately 22%, 32% and 35%. The three percent differential between middle class America and the wealthiest Americans does not reinforce the fairness and equity of the President's proposal. This three percent differential is reduced even more when one considers the proposed lower tax rate for capital gains and the link between allowable interest deductions and investment income. These proposals will also primarily benefit the rich.

In light of the complete tax burden picture, Congress might wish to consider retaining deductibility of state and local taxes in return for raising the top bracket from 35 percent to 40 percent. Other options, such as retaining deductibility and adding a fourth bracket to further differentiate between the middle class and the wealthy, warrant investigation.

If there is to be any fair and simple tax reform, there must be compromises which will retain deductions that are widely used and important to American principles and values. As my remarks indicate, I believe the deduction for state and local taxes meets this fundamental test. Any proposal to eliminate state and local tax deductibility should be resisted as contrary to basic intergovernmental philosophies and respect, and against the interests of a healthy and strong union of American states.

STATEMENT OF
The NATIONAL ASSOCIATION OF HOME BUILDERS
to the
SUBCOMMITTEE ON INTERGOVERNMENTAL RELATIONS
of the
COMMITTEE ON GOVERNMENTAL AFFAIRS
UNITED STATES SENATE
ON
PROPOSED REPEAL OF DEDUCTIONS
FOR STATE AND LOCAL TAXES

June 26, 1985

Mr. Chairman and Members of the Subcommittee:

The National Association of Home Builders (NAHB) with a membership exceeding 133,000, is a trade association of the homebuilding industry. NAHB appreciates this opportunity to submit a written statement concerning its views of the portion of the President's tax reform proposals that would repeal the itemized deduction for State and local taxes.

The Federal Government long has been committed to encouraging housing and has used tax policy as a significant and conscious instrument of Federal policy to attain housing goals. Several important tax incentives have been established for owner-occupied housing. These include the deductions for real property taxes and the mortgage interest deductions. These deductions make homeownership affordable for many Americans. For example, take a married couple with two children and filing a joint return. Under current law, and assuming a family income of $35,000 per year, these deductions help the family afford a $74,000 home. Without these deductions, the same family could afford only a $59,000 home. With the median price of a new home in the $80,000 range, the importance of these deductions in permitting ownership of a home is evident.

Based upon our preliminary analysis of the proposed changes in the tax treatment of homeowners, the overall after-tax cost of homeownership for a typical recent homebuyer with $40,000 of income would be increased by about 17 percent. A large portion of this increased cost would result from the disallowance of State and local taxes as itemized deductions.

As a result of this increase in homeownership cost, home prices are likely to decline moderately. This decline in home prices would be an advantage to first-time buyers, but the two-thirds of U.S. households who currently own homes would face a decline in the value of their homes, which would represent a significant hardship. Furthermore, such a decline would undoubtedly produce an increase in mortgage defaults and foreclosures.

This decline in house prices is unlikely to be large enough to offset the increase in after-tax homeownership costs. Ultimately, house prices are determined by the cost of building additional homes, and, except for the cost of raw land, these costs are not likely to fall. Thus, the net cost of homeownership after the markets have fully adjusted would still increase.

While our primary concerns are that the proposal would cause a reduction in the number of families who can afford to purchase a home and would tend to depress property values, penalizing those families who already have purchased homes, we also are concerned about the proposal's potential impact on new construction. If the State and local tax deduction is repealed, this could force localities to look to other sources to fund infrastructure. For example, they may turn to increased fees on new developments. Thus, builders could be forced to bear the burden for infrastructure costs that more properly should be funded out of general revenues. Ultimately, these fees would result in increased cost of new construction that would be reflected in increased housing costs.

Finally, it should be noted that when the Federal income tax was first enacted in 1913, Congress included the deduction for State and local taxes. The expressed purpose of the deduction was to avoid the burdensome effects of double taxation. The President's proposal would reverse this and would impose double taxation on individuals. However, the President's proposal would allow corporations to continue to offset taxes paid overseas with the foreign tax credit.

In conclusion, the National Association of Home Builders urges that, in its consideration of tax reform, Congress preserve the deduction for State and local taxes because of its relevance to homeownership costs. We applaud the efforts of the Subcommittee in this regard and appreciate the opportunity to submit our views.

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202-861-6500

Mortgage Bankers Association of America

STATEMENT OF

MORTGAGE BANKERS ASSOCIATION OF AMERICA

for submission
to the

SUBCOMMITTEE ON INTERGOVERNMENTAL RELATIONS

of the

COMMITTEE ON GOVERNMENTAL AFFAIRS

UNITED STATES SENATE

on

The Deductibility of State and Local Taxes

June 26, 1985

The Mortgage Bankers Association of America[*] submits this statement on the deductibility of real property taxes. The President's Tax Proposals to the Congress for Fairness, Simplicity and Growth provide for the elimination of the deductibility of real property taxes by homeowners.

From its inception, the tax code has recognized the importance of homeownership as a priority in the American value system. It has been tax policy to make homeownership affordable for as many Americans as possible. Purchasing a home is the biggest expenditure most Americans will ever make. The annual cost of owning a home is a large part of the budget of most Americans and is very sensitive to provisions in our tax laws. This has been the overriding reason for including provisions in the Internal Revenue Code which act as incentives to Americans to save for and purchase their own homes.

In addition to being able to deduct their home mortgage interest expenses, current tax law allows Americans to deduct state and local real property taxes from their adjusted gross income. This makes homeownership more available by reducing the effective cost of owning a home. Thus, by reducing the after-tax cost of homeownership, the tax code has enhanced the ability of Americans to afford their own homes.

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[*] The Mortgage Bankers Association of America is a nationwide organization devoted exclusively to the field of mortgage and real estate finance. MBA's membership comprises mortgage originators, mortgage investors, and a variety of industry-related firms. Mortgage banking firms, which make up the largest portion of the total membership, engage directly in originating, financing, selling, and servicing real estate investment portfolios. Members include:

- Mortgage Banking Companies
- Mortgage Insurance Companies
- Life Insurance Companies
- Commercial Banks
- Mutual Savings Banks
- Savings and Loan Associations
- Mortgage Brokers
- Title Companies
- State Housing Agencies
- Investment Bankers
- Real Estate Investment Trusts

MBA headquarters is located at 1125 15th Street, N.W., Washington, D.C. 20005; telephone: (202) 861-6500.

The President's tax proposals focus on the lowering of marginal tax rates for individuals. In order to do this without losing revenue, the amount of income subject to taxation is increased in the proposal by the elimination or restriction of deductions, credits, and preferences. The President's tax reform proposal has been fostered by the general impression that the current tax code is unfair, overly complex, and a hindrance to economic growth. The impact of the changes embodied in this proposal will cause Americans to reevaluate their shelter decisions.

Lower Marginal Tax Rates and Repeal of Deductibility of State and Local Real Property Taxes

The following discussion is simply intended to analyze the impact of lower marginal tax rates and the repeal of the deductibility of state and local real property taxes because these two provisions of the President's tax proposals would most directly impact the American homeowner. MBA's analysis indicates that these provisions would increase the after-tax cost of homeownership. Although mortgage interest paid on principal residences would remain fully deductible, the value of housing related deductions would be reduced. This would adversely affect the relative price of housing.

For the homeowner who is a taxpayer at the margin, any increase in disposable income due to lower marginal tax rates would be offset by the repeal of the deductibility of state and local real property taxes. For the marginal borrower, the relative increase in the cost of housing could make it more difficult to afford a home and qualify for a mortgage.

MBA's analysis isolated two proposals—the loss of the deductibility of state and local real property taxes and the lowering of marginal tax rates—and kept all other factors constant.

MBA's study does not consider any changes in disposable income as result of other provisions of the tax proposal.

MBA's study reveals that the after-tax cost of owning a house increases in the 35 cities included in the study, regardless of whether the state is a low- or high-tax state. (See attached Exhibit.)

MBA's study analyzed the impact of these two provisions on the first year of homeownership for a married couple with two children filing a joint tax return in three income groups: $25,000, $50,000, and $100,000.

Average Increase in After-Tax Costs of Homeownership

Family Income	Yearly Pre-Tax Cost*	After-Tax Cost Current	After-Tax Cost Proposal	Average Percent Increase
$ 25,000	$ 9,164	$ 7,583	$ 8,238	8.6%
$ 50,000	$14,536	$10,107	$11,999	18.6%
$100,000	$21,384	$13,619	$16,069	17.9%

*Includes mortgage payments, property taxes, and estimated utilities, maintenance and insurance costs.

No family income group in this analysis has its homeownership costs reduced by the President's tax proposals. Middle- and upper-income families experience the greatest increase in costs associated with the reduction of marginal tax rates and the repeal of the deductibility of real property taxes and therefore are the most adversely affected by the tax proposal.

MBA encourages Congress to scrutinize carefully the President's tax proposals as well as Congress' own proposals, because a careful analysis of the Internal Revenue Code is long overdue. While engaging in this analysis, however, MBA urges Congress not to lose sight of the important social purpose of adequate housing that is currently encouraged by a variety of provisions embodied in the present tax code.

MBA appreciates this opportunity to present its views and would be happy to provide additional information if necessary.

EXHIBIT

IMPACT OF THE PRESIDENT'S TAX REFORM PROPOSAL ON THE AFTER-TAX COST OF THE FIRST-YEAR OF HOMEOWNERSHIP, BY FAMILY INCOME, FOR A MARRIED COUPLE WITH TWO CHILDREN*

	$25,000			$50,000			$100,000		
Metropolitan Area	Current Law After-Tax Cost	After-Tax Cost Under President's Proposal	% Increase	Current Law After-Tax Cost	After-Tax Cost Under President's Proposal	% Increase	Current Law After-Tax Cost	After-Tax Cost Under President's Proposal	% Increase
BIRMINGHAM, AL	$7,098	$7,617	7.3 %	$9,497	$11,015	16.0 %	$12,821	$14,619	14.0 %
LITTLE ROCK, AR	$7,337	$7,923	8.0 %	$9,798	$11,500	17.4 %	$13,214	$15,333	16.0 %
LOS ANGELES, CA	$7,243	$7,803	7.7 %	$9,680	$11,310	16.8 %	$13,060	$15,053	15.3 %
DENVER, CO	$7,243	$7,803	7.7 %	$9,680	$11,310	16.8 %	$13,060	$15,053	15.3 %
BRIDGEPORT, CT	$7,734	$8,433	9.0 %	$10,298	$12,307	19.5 %	$13,868	$16,523	19.1 %
WILMINGTON, DE	$7,243	$7,803	7.7 %	$9,680	$11,310	16.8 %	$13,060	$15,053	15.3 %
JACKSONVILLE, FL	$7,411	$8,019	8.2 %	$9,892	$11,652	17.8 %	$13,337	$15,557	16.6 %
ATLANTA, GA	$7,430	$8,043	8.3 %	$9,916	$11,690	17.9 %	$13,368	$15,613	16.8 %
HONOLULU, HI	$7,182	$7,725	7.6 %	$9,603	$11,186	16.5 %	$12,960	$14,871	14.7 %
DES MOINES, IA	$8,015	$8,793	9.7 %	$10,652	$12,877	20.9 %	$14,330	$17,363	21.2 %
BOISE, ID	$7,416	$8,025	8.2 %	$9,898	$11,661	17.8 %	$13,345	$15,571	16.7 %
CHICAGO, IL	$7,589	$8,247	8.7 %	$10,116	$12,013	18.7 %	$13,630	$16,089	18.0 %
INDIANAPOLIS, IN	$7,589	$8,247	8.7 %	$10,116	$12,013	18.7 %	$13,630	$16,089	18.0 %
WICHITA, KS	$7,374	$7,971	8.1 %	$9,845	$11,576	17.6 %	$13,275	$15,445	16.3 %
NEW ORLEANS, LA	$7,374	$7,971	8.1 %	$9,845	$11,576	17.6 %	$13,275	$15,445	16.3 %
BOSTON, MA	$8,076	$8,871	9.8 %	$10,728	$13,001	21.2 %	$14,430	$17,545	21.6 %
PORTLAND, ME	$7,861	$8,595	9.3 %	$10,457	$12,564	20.1 %	$14,076	$16,901	20.1 %
DETROIT, MI	$8,605	$9,549	11.0 %	$11,394	$14,074	23.5 %	$15,300	$19,127	25.0 %
MINNEAPOLIS, MN	$7,753	$8,457	9.1 %	$10,322	$12,345	19.6 %	$13,899	$16,579	19.3 %
ST.LOUIS, MO	$7,369	$7,965	8.1 %	$9,839	$11,566	17.6 %	$13,268	$15,431	16.3 %
BILLINGS, MT	$7,407	$8,013	8.2 %	$9,886	$11,642	17.8 %	$13,329	$15,543	16.6 %
FARGO, ND	$7,514	$8,151	8.5 %	$10,022	$11,861	18.3 %	$13,506	$15,865	17.5 %
OMAHA, NE	$7,875	$8,613	9.4 %	$10,475	$12,592	20.2 %	$14,099	$16,943	20.2 %
MANCHESTER, NH	$7,964	$8,727	9.6 %	$10,587	$12,773	20.6 %	$14,246	$17,209	20.8 %
NEWARK, NJ	$8,118	$8,925	9.9 %	$10,781	$13,086	21.4 %	$14,500	$17,671	21.9 %
NEW YORK, NY	$7,514	$8,151	8.5 %	$10,022	$11,861	18.3 %	$13,506	$15,865	17.5 %
CLEVELAND, OH	$7,528	$8,169	8.5 %	$10,039	$11,889	18.4 %	$13,529	$15,907	17.6 %
OKLAHOMA CITY, OK	$7,182	$7,725	7.6 %	$9,603	$11,186	16.5 %	$12,960	$14,871	14.7 %
PORTLAND, OR	$7,772	$8,481	9.1 %	$10,346	$12,383	19.7 %	$13,930	$16,635	19.4 %
PHILADELPHIA, PA	$7,730	$8,427	9.0 %	$10,293	$12,298	19.5 %	$13,861	$16,509	19.1 %
PROVIDENCE, RI	$8,170	$8,991	10.1 %	$10,846	$13,191	21.6 %	$14,584	$17,825	22.2 %
COLUMBIA, SC	$7,229	$7,785	7.7 %	$9,662	$11,281	16.8 %	$13,037	$15,011	15.1 %
MEMPHIS, TN	$7,599	$8,259	8.7 %	$10,128	$12,032	18.8 %	$13,645	$16,117	18.1 %
HOUSTON, TX	$7,753	$8,457	9.1 %	$10,322	$12,345	19.6 %	$13,899	$16,579	19.3 %
CASPER, WY	$7,093	$7,611	7.3 %	$9,492	$11,006	16.0 %	$12,813	$14,605	14.0 %
AVERAGE =	$7,583	$8,238	8.6 %	$10,107	$11,959	18.6 %	$13,619	$16,069	17.9 %

PREPARED BY MBA ECONOMICS DEPARTMENT, JUNE 1985.

*Assumes a 12½ percent 30-year, fixed-rate mortgage with a 10 percent downpayment. Property taxes for each location are derived from effective local property tax rates as estimated by the Advisory Commission on Intergovernmental Relations. House prices for each income category are derived from U.S. Bureau of the Census data. Total housing costs are the sum of mortgage payments, property taxes and an estimate of the costs of maintenance, utilities, and insurance.

Note: Pre-tax housing costs are assumed to be the same in every city for each respective income category. This was done to isolate the effect the changes in marginal tax rates, combined with the loss of the property tax deduction,would have on the after-tax cost of homeownership, by city. These assumed housing costs are not intended to reflect actual housing costs in every city.

aascu

American Association of State Colleges and Universities One Dupont Circle/Suite 700/Washington, D.C. 20036-1193 (202) 293-7070

July 17, 1985

Hon. David Durenberger
Chairman
Intergovernmental Relations Subcommittee
432 Hart Office Building
Washington, D.C. 20510

Dear Senator Durenberger:

On June 25, 1985, the Intergovernmental Relations Subcommittee held hearings on the impact of the proposed elimination of the deductibility of state and local taxes from federal income taxes. The American Association of State Colleges and Universities, an association of 366 public four-year colleges and universities, and the associations listed herein, would like to submit for the record the enclosed statement on the effects on higher education of the proposed elimination of deductibility.

Sincerely,

Richard Novak

Richard Novak
Assistant Director
Office of Governmental Relations

Chairman: Aubrey K. Lucas, President, University of Southern Mississippi; Chairman-Elect: Ronald Williams, President, Northeastern Illinois University; Past-Chairman: Joseph J. Orze, President, Northwestern State University of Louisiana; Secretary/Treasurer: Myron L. Coulter, Chancellor, Western Carolina Univer ty, NC; President: Allan W. Ostar.

Directors: Harold Abel, President, Central Michigan University; Frank H. Blackington III, President, University of Pittsburgh at Johnstown, PA; Alice Chandler, President, State University College at New Paltz, NY; Henry Givens, President, Harris/Stowe College, MO; Stephen Horn, President, California State University, Long Beach; Eugene M. Hughes, President, Northern Arizona University; William J. Maxwell, President, Jersey City State College, NJ; Arliss Roaden, President, Tennessee Technological University; Betty Lentz Siegel, President, Kennesaw College, GA; Hoke L. Smith, President, Towson State University, MD; Lloyd I. Watkins, President, Illinois State University; Del Weber, Chancellor, University of Nebraska at Omaha.

Cable Address: AASCU-Washington, D.C.

HIGHER EDUCATION AND THE DEDUCTIBILITY OF STATE AND LOCAL TAXES

WRITTEN STATEMENT FOR THE INTERGOVERNMENTAL RELATIONS SUBCOMMITTEE

OF THE

SENATE GOVERNMENT AFFAIRS COMMITTEE

ON BEHALF OF THE

American Association of State Colleges and Universities
American Council on Education
American Association of Community and Junior Colleges
Association of Urban Universities
National Association of State Universities and Land-Grant Colleges
The City University of New York
State Higher Education Executive Officers

July 17, 1985

Mr. Chairman and Members of the Subcommittee:

As the Intergovernmental Relations Subcommittee explores the impact of the removal of the deduction for state and local taxes on our system of federalism, we hope that its benefits to public higher education are not overlooked. Higher education is opposed to the elimination of deductibility as proposed in the President's tax reform proposal. We support the full deductibility of all current tax payments for sales, income, real and personal property.

The elimination of the state and local tax deduction will lead to an eventual decrease in state and local tax collections, a reduction in the size of state and local governments and a subsequent current dollar decrease in the funding for state and local services. Education is the largest state and local service comprising nearly 40% of the state and local tax dollar and highly susceptible to funding decreases. Any occurence that has a negative impact on the state and local tax base (be it a state recession, a decrease in the world price of a state's chief resource, etc.) has a subsequent negative effect on public education. Repealing deductibility would ultimately have a similar and permanent effect.

Taxpayer reactions to the loss of the price subsidy effects of the deductibility of property taxes will be felt not only by counties, towns and townships, and elementary and secondary education, but also by community and junior colleges who rely on local property taxes for a substantial portion of their budgets. The effects on higher education will be felt most, however, as the eventual effects of the repeal of deductibility are felt in state tax collections. Public two and four year institutions receive anywhere from 40% to 60% of their budgets from state governments. These monies are almost exclusively tax driven dollars, primarily from state sales and income taxes. Higher education is the third or fourth largest item in state budgets. In 1983, the states alone appropriated $36 billion to higher education institutions; taxpayers in local jurisdictions approved another $8 billion (largely to community and junior colleges). The nature of the direct appropriations process to state higher education institutions makes their budgets a more likely target than the "committed" funds for state welfare entitlements, matching requirements for federal funds, employee insurance and retirement, and bond indebtedness. We have estimated that even by the modest declines projected by the Advisory Commission on Intergovernmental Relations, higher education nationally would experience a decline of one to two billion dollars per year in 1983 dollars. Institutions in the state of Minnesota would lose from $25 to $51 million per year in 1983 dollars; (see attached).

Educational reform is taking place at all levels of education; much of it school district and institution initiated, but much of it also directed and financed by state governments. If that reform movement is to continue then the citizens of states and local school districts will need incentives to to support funding increases for education. It is poor public policy to repeal deductibility, creating negative effects on state and local tax capacity, thereby hurting education.

Specifically in higher education, repealing deductibility would greatly hamper the opportunity for new state monies to be invested in quality and innovative programs and deprive many institutions of monies for the margin of excellence which they seek to attain. In addition, colleges and universities need "catch-up" monies to fund state of the art laboratory and scientific equipment, to pay for competitive faculty salaries, and to finance physical plant maintenance deferred in recent years. The probable decline in state and local support for higher education would come just at the time when many states have begun to reinvest in higher education after a time period of reduced support, and at a time when the Federal share of education is declining. The President's new federalism should encourage rather than discourage the assumption by states of responsibility for the welfare of their citizens.

aascu

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THE LOSS OF DEDUCTIBILITY OF STATE AND LOCAL TAXES FROM FEDERAL INCOME TAXES: YEARLY REDUCTIONS IN TOTAL HIGHER EDUCATION STATE APPROPRIATIONS IN 1983 DOLLARS (PROJECTED)

Alabama	$17.1 million	$34.2 million
Alaska	Minimal	.24
Arizona	17.8	35.7
Arkansas	6.6	9.9
California	118.3	276.0
Colorado	29.1	50.1
Connecticut	11.2	18.7
Delaware	6.0	12.0
Florida	17.3	34.6
Georgia	16.5	41.2
Hawaii	8.2	16.5
Idaho	3.3	6.5
Illinois	40.5	80.9
Indiana	20.9	41.7
Iowa	11.7	23.3
Kansas	13.4	26.9
Kentucky	12.4	31.1
Louisiana	16.5	32.9
Maine	1.6	4.9

Chairman, **Aubrey K. Lucas**, President, University of Southern Mississippi; Chairman-Elect, **Ronald Williams**, President, Northeastern Illinois University; Past-Chairman, **Joseph J. Orze**, President, Northwestern State University of Louisiana; Secretary/Treasurer, **Myron L. Coulter**, Chancellor, Western Carolina University, NC; President, **Allen W. Ostar**.

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Cable Address: AASCU-Washington, D.C.

Maryland	27.8 million	48.6 million
Massachusetts	17.3	40.4
Michigan	66.1	115.6
Minnesota	25.7	51.4
Mississippi	7.1	10.6
Missouri	11.9	29.9
Montana	2.7	4.1
Nebraska	9.9	14.8
Nevada	3.0	6.0
New Hampshire	1.4	4.2
New Jersey	22.1	44.3
New Mexico	7.3	11.0
New York	82.7	165.5
North Carolina	19.3	38.6
North Dakota	3.9	5.8
Ohio	36.4	91.0
Oklahoma	15.3	38.2
Oregon	13.4	27.0
Pennsylvania	19.0	38.0
Rhode Island	5.1	8.6
South Carolina	11.3	28.3
South Dakota	1.2	2.4
Tennessee	14.2	21.3
Texas	54.3	81.4
Utah	18.4	32.3

Vermont	2.7	6.8
Virginia	30.2	60.4
Washington	19.4	48.5
West Virginia	2.9	5.8
Wisconsin	30.6	61.2
Wyoming	1.1	3.4
U.S. Total	$952.1 million	$1.9 billion

These figures show a one to two billion constant dollar yearly decline in state support for higher education (in 1983 dollars) if deductibility were to be eliminated. These projected declines are probably modest.

The figure in the lefthand column is based upon 1983 total state spending for higher education multiplied by the estimated midpoint percentage decline in total state and local spending. That figure ranges from one percent to four percent for the fifty states. The figure in the righthand column is based upon total state spending multiplied by the maximum projected decline. That figure ranges from one percent to eight percent for the fifty states. These percentage declines in state spending are from research prepared by the Advisory Commission on Intergovernmental Relations and are generally **lower** than those prepared by other researchers.

The listed reductions presume the proportionally rule, i.e. state governments would treat all state expenditures equally when undergoing reductions (or percentage declines) in appropriations. This presumption may also lead to modest projection. Overall, state expenditures are approximately 51 percent "tax-driven;" however, higher education expenditures within each state budget are nearly 100 percent from state taxes and the basis for direct state appropriations. The columns do not include reductions in local government support for higher education. In 1982 local government support totalled over $7 billion, largely to two-year colleges.

Calculated from:

State Government Finances in 1983. U.S. Department of Commerce, Bureau of the Census, September 1984.

Kenyon, Daphne, Senior Analyst. Federal Income Tax Deductibility of State and Local Taxes, (Discussion Draft). Advisory Commission on Intergovernmental Relations. April 1985.

For further information contact:

Richard Novak
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July 17, 1985

TESTIMONY OF
RICHARD S. WILLIAMSON
BEFORE THE
SENATE SUBCOMMITTEE ON INTERGOVERNMENTAL RELATIONS
JUNE 26, 1985

I wish to commend Chairman David Durenberger and the members of the Senate Committee on Governmental Affairs Subcommittee on Intergovernmental Relations for holding hearings on the federal income tax deduction for state and local taxes. I also wish to thank Senator Durenberger for inviting me to submit testimony on this important topic. In light of President Reagan's sweeping tax reform proposals and the provisions in the Administration's proposal to eliminate the federal tax deductibility of state and local taxes, there are few topics of greater concern to those interested in our federal system.

I favor the President's proposal.

I have listened carefully to the opponents of this reform, and some important arguments are raised against the elimination of the federal tax deductibility of state and local taxes. However, on the other side, there are compelling arguments for this reform which, I believe on reflection, are persuasive.

Opponents of the President's reform argue that it pits the 15 "high tax" states against the other 35. This charge suggests that such competition amongst states does not exist already. In fact, it does. There is competition amongst the states as Congress deals with federal programs and distribution formulas for new programs and revisits targeting for existing ones. There is competition amongst the states in dealing with departments and agencies as each seeks to get its fair share, and more, of limited federal dollars in grants, etc. The majority of states have offices in Washington, D.C. to wage just such competition in the halls of Congress and amongst the federal agencies.

I am not suggesting such competition is bad, but rather to put in perspective and appropriately discount the charge that this reform somehow is wrongheaded because it heightens competition amongst the states. Tax deductibility is but one of the many areas where competition already exists for the approximately $150 billion in aid the federal government provides to state and local governments (grants-in-aid and tax deductibility).

Opponents of this reform also argue that the cruelest effect in "high tax" states would be on welfare programs and medicaid benefits for the poor. This charge is based on a false presumption that states and local governments, when faced with tough fiscal decisions, are somehow less compassionate than the federal government. In recent years state and local governments have been faced with a significant federal retrenchment of grant-in-aid assistance and a recession that forced them to make extremely difficult budget decisions. The simple fact is that state and local governments faced these tough choices directly -- even raising taxes as necessary -- and with compassion. Both academic studies and press reports have clearly documented this phenomenon.

Some critics of this reform proposal say that it will harm school budgets. Again, recent history argues against such an assertion. During the past few years of major fiscal restraint and even crisis in many state capitols, most have revitalized, reformed and sought to improve education. These reforms range from Mississippi's decision to increase taxes to enable the state to initiate kindergarten in their schools, to the just-passed education reform bill in Illinois. There is recognition in city halls and state capitols that improved education is vital to develop good citizens and skilled workers; improved education is vital for states to compete for economic growth.

Then there is the cluster of charges critics make that the elimination of state and local tax deductibility will do damage to "federalism." They point out that if adopted this reform proposal would abruptly end a pattern of federal-state relations that has governed policy-making for more than 70 years, since the beginning of the modern income tax. They argue that we need to guard the vitality of state and local government, and this reform proposal would usurp still more traditional local tax sources for the federal treasury. And that, as costs rise, resistence to any kind of tax increase at the local and state level would be greater than now because the full weight would be felt by the individual taxpayer and not shared through deductibility with Washington.

I take this cluster of arguments very seriously. But, on balance, I believe this reform will do more to help federalism than harm it.

It is important to guard the vitality of state and local governments. Few have done more than President Reagan to encourage vitality, experimentation and diversity within our intergovernmental system. Most dramatically in cutting vast numbers of federal regulations over grants-in-aid and in creating major block grants, President Reagan has freed state and local governments. It is a freedom that has been well exercised.

Further, the overall pool of resources for state and local governments is much more dependent on a healthy economy than on deductibility. The President's tax reform package will make a clean sweep of the accumulation of inequities and inefficiences that now plague our tax code. By closing some 65 existing preferences, it aims not only to re-establish fairness, but to open the door to more productive investment and growth. Most current economic distortions caused by existing tax preferences would disappear and capital could flow to where there would be maximum economic growth not maximum tax shelter. The overall result, of course, will be improved economic growth. That economic growth, in turn, provides economic vitality to states and localities.

Also, a principal goal of sorting out responsibilites in our federal system is to provide for clearer accountability. That accountability, in turn, encourages greater citizen participation in government. If a citizen does not know who is responsible for what goes right or what goes wrong in government, he has less incentive to vote. After all, what difference does it make? Therefore, to move from cooperative federalism to sorting out responsibilities in our intergovernmental system has been recognized increasingly as a worthwhile federalism reform. The President's proposal to eliminate deductibility does just that.

Currently, the full weight of local and state taxes is not felt by the taxpayers. Close to $40 billion of the cost is passed on to the federal government. This is not good. Those who spend money at whatever level of government should bear the full political cost of raising the money they intend to spend. Citizens should be allowed to judge whether the full cost of their government at each level is justified by the services and benefits provided therefrom. The bill should be up front and clear. Citizens then can exercise an informed judgment at the ballot box and take more control over their governments. This is not a chilling effect on state and local governments, but an invigorating one. For with more clear responsibility there can be more effective accountability and that is good in a democracy. More citizen participation invigorates local, state and federal government.

Present law permitting deductibility of state and local taxes encourages growth of state and local budgets by making it easier to raise their taxes. In a time of great fiscal restraint, is this good?

The approximately $40 billion cost of deductibility is a lot of money. With $200 billion-plus federal deficits, is this the best expenditure of scarce federal dollars?

Tax expenditures such as the federal deductibility of state and local taxes are inefficient. In a time of budget crisis, can we afford a $40 billion expenditure that is inefficient?

Only approximately the top 1/3 of income tax payers itemize their federal taxes and, therefore, only the very well off benefit from the deductibility tax break. As the federal government retrenches in so many areas and curbs benefits to the less well off, should we continue a $40 billion tax break for the well off?

President Reagan has made a bold tax reform proposal. In sum, including the elimination of tax deductibility, it is a sound proposal which, if enacted, would benefit our intergovernmental system.

The Heritage Foundation Issue Bulletin

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June 14, 1985

REAGAN'S TAX REVOLUTION: ENDING THE FREE RIDE FOR STATE & LOCAL TAXES

INTRODUCTION

Ronald Reagan's proposal to eliminate the deductibility of state and local nonbusiness taxes from the federal tax base is among the most controversial provisions in his tax reform plan.[1] This deduction has existed since the creation of the federal income tax in 1913. Yet there is a strong case for eliminating it as an integral part of an overall tax reform. Today's deduction for state and local taxes favors the rich over the poor and affluent states over low-income states, and it discourages more efficient methods of financing and delivering state and local services. As such, its elimination is one of the most important provisions in the Reagan tax plan and is central to the attempt to make the U.S. tax system fairer and simpler.

This is the first of a series on the President's tax reform plan. Future studies will examine the plan's impact on families and the poor, international finance and trade, energy policy and industries, financial institutions, and savings investment and risk-taking. For a brief overview of the plan, see Bruce Bartlett, "Two Cheers for the Reagan Tax Revolution," Heritage Foundation Executive Memo No. 81, May 29, 1985. For an analysis of the President's earlier tax plan, Treasury I, see Grover Norquist, "One Cheer for the Treasury Tax Plan," Heritage Foundation Backgrounder No. 397, December 17, 1984.

[1] The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity (Washington, D.C.: Government Printing Office, 1985), pp. 62-69; Milton Coleman, "Ending State, Local Deduction Controversial," The Washington Post, May 29, 1985, p. A15; Jacob Javits, "The Treasury's Trojan Horse," The New York Times, May 14, 1985; Editorial, "Guess Who Pays for Tax 'Reform,'" The New York Times, May 26, 1985.

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

THE INEQUALITIES OF THE DEDUCTION

Under current law a taxpayer who itemizes is allowed to deduct from his adjusted gross income all income, sales, and property taxes paid to state and local governments. On the other hand, those who do not itemize--approximately two-thirds of all taxpayers--receive no advantage from this deduction.

A Benefit for the Rich

The benefits of this tax break accrue largely to more wealthy taxpayers, partly because they tend to pay more state and local taxes and partly because each dollar of the deduction is worth more for those in the higher marginal tax brackets. As Table 1 illustrates, those with economic incomes above $50,000 account for two-thirds of the deduction for state and local taxes.

TABLE 1

Percent of Total Deduction for State and Local Taxes
by Income Class, 1983

Income Class	Percent
$ 0 - 9,999	0.3
10,000 - 14,999	0.5
15,000 - 19,999	1.2
20,000 - 29,999	6.1
30,000 - 49,999	25.4
50,000 - 99,999	42.0
100,000 - 199,999	14.0
200,000 or more	10.5

Source: Treasury Department.

The deduction for state and local taxes is among the fastest growing tax breaks. In 1970, $32 billion of these taxes were deducted at the federal level. By 1983 this figure had ballooned to over $100 billion.[2] The Congressional Budget Office estimates that eliminating deductibility would raise federal revenues by $176.2 billion between 1986 and 1990, in the absence of any other tax change, assuming there is no impact on economic growth.[3] The

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[2] Internal Revenue Service, Statistics of Income Bulletin 4 (Spring 1985), p. 78.

[3] Congressional Budget Office, Reducing the Deficit: Spending and Revenue Options (Washington, D.C.: Government Printing Office, 1985), p. 291.

Treasury Department estimates that eliminating deductibility would raise revenues by $148.9 billion[4] between 1986 and 1990 if it were part of an overall tax reform proposal that also lowers marginal tax rates. The difference between the two figures is largely due to the fact that under current law the top tax rate rises to 50 percent while under the President's proposal it would be no higher than 35 percent.

A Break for Rich States

The value of deductibility for taxpayers varies widely between states. It predictably is greatest in those states where taxes are the highest. The Advisory Commission on Intergovernmental Relations (ACIR) estimates the tax savings from deductibility at $263 per capita for a New York resident, but only $33 per capita for a Tennessee resident. Table II lists the figures for all states in descending order of the value of the deduction. The biggest benefits go mainly to the richer states in the northeast and the west.

Table II
Tax Saving from Deductibility of State and Local Taxes
and Per Capita Income, 1984

State	Total Tax Saving in Millions	Tax Saving Per Capita	Per Capita Income in 1983
New York	$ 4,729	$263	$12,990
Maryland	916	211	12,994
Massachusetts	1,146	195	13,264
California	4,664	185	13,257
Minnesota	761	181	11,913
Hawaii	179	177	12,114
Michigan	1,619	175	11,466
Delaware	107	174	12,665
New Jersey	1,277	169	14,122
Wisconsin	820	169	11,352
Connecticut	480	150	14,895
Oregon	389	144	10,740
Colorado	426	137	12,770
Virginia	712	127	12,116
Rhode Island	123	126	11,670
United States	28,480	120	11,658
Illinois	1,390	119	12,405
Iowa	307	104	10,705
Alaska	45	101	17,194
Nebraska	162	101	11,212
Utah	160	101	8,993
Pennsylvania	1,199	99	11,448
Arizona	274	94	10,656

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[4] President's Tax Proposals, op. cit., p. 453.

State	Total Tax Saving in Millions	Tax Saving Per Capita	Per Capita Income in 1983
Vermont	49	93	9,979
Kansas	218	89	12,247
North Carolina	537	88	9,787
Georgia	492	86	10,379
Idaho	82	84	9,555
Ohio	904	82	11,216
Montana	64	78	9,949
South Carolina	253	78	9,187
Missouri	384	76	10,969
Kentucky	280	75	9,397
Maine	87	75	9,847
New Hampshire	72	74	12,021
Oklahoma	240	74	10,963
Alabama	251	62	9,242
Washington	260	60	12,117
New Mexico	81	59	9,640
Indiana	320	57	10,476
Arkansas	123	53	8,967
Nevada	46	52	12,451
North Dakota	31	46	11,666
Florida	478	45	11,593
Mississippi	116	45	8,098
Texas	643	41	11,685
West Virginia	79	40	9,159
Wyoming	20	39	11,911
Louisiana	151	34	10,270
South Dakota	23	33	9,847
Tennessee	154	33	9,549

Source: Advisory Commission on Intergovernmental Relations.

Because the benefits of deductibility vary so widely, the state and local tax deduction in effect forces lower-taxed states to subsidize higher-taxed states. And because the states with heavier state and local taxes tend to be wealthier in terms of per capita income, deductibility constitutes a subsidy from the poor to the rich. The 15 states with above average tax savings from deductibility, for example, have average per capita incomes over 17 percent higher than those states with less than average tax savings from deductibility.

For Itemizers Only

The deductibility of state and local taxes is also a subsidy from the poor to the rich within each state. This is because deductibility benefits only those who itemize--generally the more wealthy taxpayers. Those who use the standard deduction gain absolutely nothing from the deductibility of state and local taxes. Only 37 percent of all U.S. taxpayers itemize deductions in their tax returns. The share of itemizers in each state, however, varies from Utah's high of 50 percent to West Virginia's low of 19 percent.[a] University of Michigan economist Edward Gramlich explains in a recent study that user fees and charges, which are generally more efficient methods of raising revenue, are not deductible while less efficient sales and income taxes are. Notes Gramlich: "the deduction...merely represents an unwarranted tax break for the high-income taxpayers who do itemize."[b]

Homeowners vs. Renters

The deductibility of property taxes biases the tax code against renters and in favor of homeowners. A 1977 Treasury study notes that rents contain a share of property taxes paid by the landlord. Over time, rents will rise dollar-for-dollar with an increase in the property tax. Yet only homeowners and landlords will be relieved of part of this burden by being able to deduct such taxes from their taxable income. Renters will not.[c] And to the extent that homeowners are generally wealthier than renters, this again means that deductibility constitutes a subsidy from the poor to the rich.

This is also true of the deductibility of sales taxes, which must be paid regardless of one's income. Thus the inherent regressivity of sales tax is increased by allowing such taxes to be deducted from taxable income. A dollar's worth of sales tax will cost a dollar to taxpayers who do not itemize or whose income is so low that they pay no taxes. But it will cost someone in the top federal tax bracket only 50 cents under current law. The result: the rich enjoy government services at less cost than the poor. This deductibility, in effect, is income redistribution in reverse.

THE IMPACT OF STATE AND LOCAL SPENDING

Deductibility of state and local taxes is estimated to increase overall state and local government spending by as much as 20.5 percent, according to the Congressional Research Service.[8] The ACIR puts it at only 7 percent--which would still be about $30 billion in 1983.[9] Most other estimates put the figure at 13 to 14 percent.[10] This means that, without federal deductibility for state and local taxes, state and local spending would be about 14 percent less than it now is and would fall by this amount in the absence of deductibility. It is unlikely, of course, that it would fall immediately, but the relative pressure to raise spending would.

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[a] Strengthening the Federal Revenue System: Implications for State and Local Taxing and Borrowing (Washington, D.C.: Advisory Commission on Intergovernmental Relations, 1984), pp. 44-45.

[b] Edward M. Gramlich, "Reforming U.S. Federal Fiscal Arrangements," in John M. Quigley and Daniel L. Rubinfeld, eds., American Domestic Priorities: An Economic Appraisal (Berkeley, California: University of California Press, 1985), p. 50.

[c] Blueprints for Basic Tax Reform (Washington, D.C.: Department of the Treasury, 1977), p. 87. See also Harvey E. Brazer, "The Deductibility of State and Local Taxes Under the Individual Income Tax," in Tax Revision Compendium, Committee Print, House Ways and Means Committee, 86th Congress, 1st Session (Washington, D.C.: Government Printing Office, 1959), vol. 1, p. 414.

If the nation as a whole benefited from having state and local spending subsidized and encouraged by the federal tax code, there might be some case for keeping the deductibility. Yet, writes Harvard Professor Helen Ladd, to accept this argument, "one would have to believe that such spillovers are positive in jurisdictions with large proportions of itemizing taxpayers and zero elsewhere. In fact, the reverse is more likely to be true."[11]

HOW THE DEDUCTION BOOSTS STATE AND LOCAL TAXES

Deductibility makes state and local taxes politically easier to impose. As such, it encourages state and local governments to establish progressive income taxes in contrast to flat-rate income taxes. The advantages, notes economist Edward Moscovitch, are:

> the ability to shift a much greater share of the state income tax burden onto the federal government, and the ability to increase state income tax revenues...without increasing taxes on low- and moderate-income families.... By shifting state taxes onto those taxpayers in the highest federal tax brackets, the adoption of graduated rates increases the total amount of federal tax savings, and thereby reduces the total burden of a state income tax. In effect, adoption of graduated rates offers an opportunity for the state to participate in a form of state-initiated revenue sharing.

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[8] Nonna A. Noto and Dennis Zimmerman, *Limiting State and Local Tax Deductibility in Exchange for Increased General Revenue Sharing: An Analysis of the Economic Effects*, Committee Print, Senate Committee on Governmental Affairs, 98th Congress, 1st Session (Washington, D.C.: Government Printing Office, 1983), p. 11.

[9] *Strengthening the Federal Revenue System*, p. 48.

[10] Helen F. Ladd, "Federal Aid to State and Local Governments," in Gregory B. Mills and John L. Palmer, eds., *Federal Budget Policy in the 1980s* (Washington, D.C.: Urban Institute, 1984); Roger H. Gordon and Joel Slemrod, "A General Equilibrium Simulation Study of Subsidies to Municipal Expenditures," *Journal of Finance* 38, May 1983, pp. 585-594.

[11] Ladd, *op. cit.*, p. 196.

Moscovitch estimates that in 1973 Massachusetts could have saved over $100 million simply by shifting from a flat-rate income tax schedule to a progressive rate schedule.[14]

Marginal tax rates vary a great deal between states and localities. Several states have no income taxes whatsoever, while rates rise to over 18 percent elsewhere. Deductibility of such taxes from federal taxable income, however, cushions the impact of such tax rates, making it easier for states to impose taxes on those who are politically active but itemize their tax returns. In short, deductibility reduces the progressivity of tax rates--but again, only for those who itemize.[15] Table III illustrates the impact of deductibility and how the President's proposal will affect taxpayers in the top tax bracket among the different states.

Table III
Highest Marginal Tax Rate by State Under Current Law
and Reagan Proposal

State	Current Law (Top rate of 50% plus deductibility)	Reagan Proposal (Top rate of 35% and no deductibility)
Alabama	52.5	40
Alaska	50	35
Arizona	54	43
Arkansas	53.5	42
California	55.5	46
Colorado	54	43
Connecticut	56.5	48
Delaware	56.1	47.2
District of Columbia	55.5	46
Florida	50	35
Georgia	53	41
Hawaii	55.5	46
Idaho	53.75	42.5
Illinois	51.25	37.5
Indiana	51.5	38
Iowa	56.5	48
Kansas	54.5	44
Kentucky	53	41
Louisiana	53	41
Maine	55	45
Maryland	52.5	40
Massachusetts	58.75	52.5

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[14] Edward Moscovitch, "State Graduated Taxes--State-Initiated Form of Federal Revenue Sharing," National Tax Journal 25, March 1972, pp. 53-64.

[15] Benjamin Bridges, Jr., "Deductibility of State and Local Nonbusiness Taxes Under the Federal Individual Income Tax," National Tax Journal 19, March 1966, pp. 1-17.

State	Current Law (Top rate of 50% plus deductibility)	Reagan Proposal (Top rate of 35% and no deductibility)
Michigan	52.68	40.35
Minnesota	58	51
Mississippi	52.5	40
Missouri	53	41
Montana	55.5	46
Nebraska	54.75	44.5
Nevada	50	35
New Hampshire	52.5	40
New Jersey	51.75	38.5
New Mexico	53.9	42.8
New York	57	49
New York City	59.15	53.3
North Carolina	53.5	42
North Dakota	54.5	44
Ohio	54.75	44.5
Oklahoma	53	41
Oregon	55	45
Pennsylvania	51.18	37.35
Rhode Island	56.23	47.45
South Carolina	53.5	42
South Dakota	50	35
Tennessee	53	41
Texas	50	35
Utah	53.88	42.75
Vermont	56.5	48
Virginia	52.88	40.75
Washington	50	35
West Virginia	56.5	48
Wisconsin	55	45
Wyoming	50	35

Source: Calculated from data of the Advisory Commission on Intergovernmental Relations.

Naturally, those states with tax rates substantially above the national average worry that loss of federal tax deductibility will sharpen the differences in tax rates among the states. They know full well from past experience that taxpayers "vote with their feet" and move to states with less tax bite. It thus would become more difficult for states to finance programs of doubtful benefit to their taxpayers by "hiding" the full cost within the federal tax system.

It should be no surprise that states protesting the proposed tax loss of tax deductibility most loudly are mainly those, such as New York, that are high taxers and big spenders. Many of these states have offset the recent decrease in federal subsidies with increased state spending, cushioned by the deductibility of state taxes, which has meant that the increased taxes have been borne partially by Uncle Sam. Now they fear that they will have to cut back on the spending that is currently subsidized by the federal tax code. And well they may. Loss of deductibility of state and local taxes could trigger the most powerful tax revolt since 1978, the days of Proposition 13 in California. It threatens the political livelihood of spendthrift lawmakers across the nation.

The Privatization Option

Despite the loud complaints of many state and local politicians, making it more difficult for them to raise taxes does not mean that government cannot carry out its obligations. The main activity of state and local governments, in contrast to the federal government, is to deliver goods and services--police and fire protection, trash collection, education, parks, and similar services. In 1983, for example, 95.8 percent of all state and local spending went to providing goods and services, according to the Department of Commerce, compared with only 32.9 percent of federal spending. Numerous studies show, however, that it is far less expensive to provide most of these goods and services through the private sector.[14] Municipal and state governments therefore could cut costs dramatically by contracting with private firms to provide a broad array of services. Even now, condominium residents and other citizens' groups shop around for such services as garbage pickup and security and end up paying less for them than if they paid local taxes for the services. But since such private fees are not deductible from federal taxable income, while payments of local taxes are, after-tax cost of private services is often higher to the taxpayer than such services funded by taxes. With the loss of deductibility, therefore, privatization and contracting out of state and local government services are no longer at a disadvantage.

CONCLUSION

Without the elimination of the deduction for state and local taxes, tax reform is essentially impossible. Without the $149 billion revenue gain from this provision in the Reagan plan, there simply will not be enough revenue to offset more than a modest reduction in tax rates--perhaps too little to make the exercise worthwhile. Since the state and local deduction mainly benefits Americans with upper incomes, its elimination restores balance among the various income sectors. This balance disappears if state and local deductibility is kept in the tax code. Ironically, therefore, those who battle against eliminating deductibility are effectively against any tax reform--and they wish to retain a deduction that favors the rich.

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[14] E. S. Savas, Privatizing the Public Sector (Ottawa, Illinois: Caroline House Publishers, 1981); Robert Poole, Jr., Cutting Back City Hall (New York: Universe Books, 1980).

To be sure, means may be devised to make the end of the deduction less painful for state and local governments. It might be phased out over a few years to ease the fiscal impact. Or an additional tax bracket could be added between 25 and 35 percent; this would ease the loss of deductibility for the vast majority of itemizers.[15]

Whatever is done to buffer the transition, Congress must remember that deductibility benefits only a relatively small number of taxpayers in a small number of states. Congress must also recognize that the U.S. pays a heavy price in terms of economic efficiency for a tax system riddled with deductions like that for state and local taxes.[16] There is no question that the nation as a whole would be better off without it even if federal tax rates are not reduced.[17] When coupled with rate reductions, the nation gains a cleaner, fairer, more efficient tax system.

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Senior Fellow

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[15] One option that definitely should not be considered is the elimination of deductibility for only selected state and local taxes. This would just cause state and local governments to alter their tax systems toward those taxes that retain deductibility. See Ladd, op. cit., p. 196.

[16] Jacquelene M. Browning, "Estimating the Welfare Cost of Tax Preferences," Public Finance Quarterly 7, April 1979, pp. 199-219.

[17] Gordon and Slemrod find that even without reducing rates eliminating deductibility "raises the utility of all income groups, and of home owners as well as of renters." Gordon and Slemrod, op. cit., p. 585.

CONSEQUENCES OF THE REPEAL OF STATE AND LOCAL TAX DEDUCTIBILITY UNDER THE U.S. PERSONAL INCOME TAX.

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I. INTRODUCTION

This paper addresses the consequences of totally or partially eliminating the deduction, by households, of State and Local (S&L) taxes from taxable income under the U.S. Personal Income Tax. This question arises naturally from the shortfall of revenues which is currently being experienced at the federal level. The tax deduction provision is estimated to cost the U.S. Treasury $28 billion in 1983 and is expected to grow further in the future.[1] The question has also arisen in connection with a larger overall effort to simplify the federal income tax which has come under the ruboric of "flat-rate" taxation. By the elimination of the myriad of exemptions and deductions that now exist, marginal tax rates could be sharply reduced, thereby increasing incentives to work and save.

Before proceding with the analysis, an important caveat is in order. The issue under consideration is extremely complex and is deserving of much more time and resources than were available to this study. These resource limitations meant that we could not pursue the empirical dimensions of our arguments. Rather we are restricted to painting a "qualitative" picture of the likely outcome of reform. Furthermore, we do not claim a great deal of originality for our arguments. Many of the salient points have already been addressed by others. Our objective was to review this work and to fill in gaps as was deemed necessary.

Our plan of attack is as follows. We begin with a discussion of the original justification for tax deductibility--that such tax payments do not constitute income--and of the arguments of its major critics, those who hold that deductibility is a form of tax expenditure. The discussion then turns to the question of the relative effectiveness of the provision as a form of fiscal relief to S&L governments. The principal alternatives considered are revenue sharing or block grants. Whether such expenditure stimulus as occurs is socially justifiable is taken up next. Several factors which tend to make S&L expenditure sub-optimal are identified.

The analysis continues with a discussion of some somewhat neglected consequences of tax deductibility. These are its impact on interstate tax competition, on the revenue structures of S&L governments, and on the distribution of income.

The final section considers partial as opposed to total repeal of deductibility. Among the alternatives considered are the elimination of the deduction for sales taxes, putting a floor under deductions, or placing a ceiling on them. The paper concludes with a discussion of its principal findings.

II. TAX DEDUCTIBILITY: A REFINEMENT OF ABILITY-TO-PAY OR A TAX EXPENDITURE?

It has become commonplace to refer to S & L tax deductibility as a tax expenditure. This term is meant to imply that the deduction's cost to the Treasury is an implicit form of Federal expenditure. If the deduction were not permitted the Federal Government could use the proceeds to finance additional expenditures and/or decrease taxes. While this terminology has intuitive appeal, closer scrutiny reveals important conceptual problems. It clearly cannot be used to describe any activity the government might not choose to tax. It would be inappropriate to conclude, for example, that because there is no federal excise tax on bread, there is a federal subsidy to bread consumption. In order to have substance, the concept of tax expenditure must be linked to a consensus of what activities should be taxed; that is, there must be broad agreement as to what constitutes an optimal tax base. Implicit in much of the literature on tax expenditure is the assumption that income is just such a tax base. Some hold that income is the best indicator of ability to pay taxes while others are attracted by the breadth of the income tax base for its efficiency advantages. Yet this support for an income base has its detractors. Some feel that consumption is a superior base while others point to the conceptual and practical difficulties in measuring income.

For the problem at hand, namely S & L tax deductions, it is not necessary to enter the debate as to whether income is the fairest or most efficient tax base. We will take this to be a working assumption. Instead, we will focus upon the question of whether S & L deductibility constitutes a form of tax expenditure.

The answer to this question rests with whether S & L tax payments constitute income. If so, their exclusion must be justified on other grounds; viz. the equity and efficiency consequences of the exclusion. If not, the concept of tax expenditures in this context is vacuous. If the S&L tax payments by individuals are matched dollar for dollar by S & L expenditure benefits, i.e. are benefit taxes, then they can be viewed properly as income. In effect, individuals would be purchasing S & L services on the same terms that they buy private goods and services.

To what extent does this quid pro quo between S & L taxpayers and governments obtain? Under the idealized conditions of the modified Tiebout model, local governments would use their zoning powers to stratify people into homogeneous housing and public service consuming communities. Differences in public expenditure benefits among communities would be fully reflected in differences in tax payments. Under the assumption of free mobility of taxpayers, each citizen could choose that combination of taxes and benefits which maximizes his/her utility. In effect, S&L taxes become perfect benefit taxes.

While the Tiebout model is suggestive of how decentralization can improve resource allocation, its stringent assumptions have little basis in reality. With the exception of certain bedroom suburban communities, localities are not perfectly or even partially stratified by income class. Even if they were, states are extremely heterogeneous, so that the Tiebout model would not apply to state expenditure.

In a heterogeneous community there will not necessarily be consensus about the level of taxation and public services. To illlustrate this, suppose individuals differ only in terms of income; i.e., they have the same tastes. Suppose further that public expenditure decisions are made by referendum according to majority rule and that people are taxed in proportion to their income.[2] In this environment, the level of public services in equilibrium will be that preferred by the voter with the median income. Moreover, the tax price confronting an individual voter is proportional to his/her share of community income; hence, it rises monotonically with income. On the other hand, for a given tax price, those with higher incomes can be assumed to prefer a larger public sector. A given voter's satisfaction with the equilibrium level of services will thus reflect these conflicting forces. It is easy to show that if the income elasticity of demand, E_I, exceeds the price elasticity of demand, E_p, those with below median income will desire a contraction of public services and those with above median incomes will desire an expansion.[3] If $E_I < E_p$, the situation is reversed.

In either circumstance, the relationship between the taxpayer and S&L governments differs materially from that between the individual and the private market. In the latter case, people pay a "tax" equal to their marginal benefit. In the former case this correspondence disappears for all but the median taxpayer. If $E_p < E_I$, the marginal benefit of the well-to-do exceeds his/her tax for additional services.[4] If $E_p > E_I$, it falls short. For those below the median income the situation is reversed.

For the issue at hand, however, we can limit our attention to the situation for the above-average income taxpayer. For it is this group which itemizes and hence enjoys the fruit of deductibility. If the marginal public service benefits of the well-to-do systematically exceed their tax prices, the case for deductibility is considerably weakened because such individuals would enjoy net fiscal benefits from the S&L sector.[5] Thus, inclusion of S&L taxes in taxable income would not overstate true income.[6]

Unfortunately, one cannot make generalizations about the marginal benefits to the above average income taxpayer.[7] S&L governments engage in a myriad of activities, many which are of different import to the well-to-do taxpayer. There are clearly categories of expenditure where the benefit (excluding altruistic benefits) to the affluent taxpayer is zero--income redistribution activities. Moreover, many of the non-explicitly redistributive programs of S&L government have a significant redistributive component. For example, expenditures for public health, remedial education, police and fire protection, and mass transit are often predicated on the socio-economic composition of the population. Areas with a high incidence of poverty are often forced to make "defensive" outlays on such programs simply to put themselves on an equal footing with affluent suburbs or neighboring states.[8] Such outlays can hardly be regarded as "beneficial" to the affluent citizen of such jurisdictions.

Even the most important local service, education, is marked by considerable redistributive elements. Households without children subsidize the education of those with children. Moreover, even though E_I may be high for education, E_p may be high for the affluent because of private school alternatives. Hence, marginal benefits may decline with income. Thus, we currently have the spectre of many central city school systems populated primarily by underpriviledged minorities.

The preceding discussion paints to a much different picture of the quid-pro-quo between a citizen and his/her state and local governments than does the Tiebout model. The existence of redistributive public expenditure programs and tax prices which increase with income substantially loosens the correspondence between S&L tax payments and public service benefits. Thus, a resident of a high tax, high social service state (e.g., the Northeast) may enjoy no more, or even less, public service benefits than a similar individual in a low tax, low social service state (e.g., in the South).[9]

To conclude this section, it seems questionable to apply the concept of tax expenditure to the deductibility of S&L taxes. The concept of income as a measure of ability to pay requires that public service benefits be included in the tax base. There is, however, no consensus about how to measure such benefits. Those who would repeal tax deductibility are implictly measuring benefit flows by tax payments. But as we have argued above, the correspondence between tax payments and benefits is too imprecise to make such a connection. If the income tax were otherwise free of loopholes the elimination of deductibility could not be advocated on the grounds of equity. Otherwise, a case for repeal would have to be based upon some sort of second-best argument; e.g. those who benefit from deductibility also enjoy other unfair favorable treatment. While this is often alleged in a broad sense -- the well-to-do have all of the loopholes -- the problem could be best resolved by eliminating the loopholes or increasing the progressivity of the rate structure; the incidence of the benefits of deductibility, while correlated with income, is not sufficiently precise to serve as a basis for increasing taxes on the rich.

While S&L taxes may not be a good indicator of public service benefit flows, it remains true that, redistributive programs aside people do receive benefits from S&L expenditures. To exempt such benefits from income taxation will bias choices towards S&L services, away from private goods and services. To what extent is such a shift desirable? On the other hand, the elimination of the deductibility of personal taxes would be bias S&L governments to choose taxes upon business, whose taxes would remain deductible. Such business taxes may well create greater inefficiencies and inequities than personal taxes. It is to these issues that we now turn.

III. TAX DEDUCTIBILITY AS A SUBSIDY TO S & L GOVERNMENTS

It is often alleged that tax deductibility constitutes a subsidy to S&L governments. An analogy is drawn to the exemption of the interest on S&L securities. Because of their tax free status, the interest cost of S&L securities is lower than otherwise, freeing budget resources for S&L governments. This analogy, however, is less than complete. In the case of tax deductibility, the subsidy is to citizen-voters and not to S&L governments themselves. Budget relief to S&L governments is afforded only insofar as voters are willing to support a larger level of S&L services; this will require the increase of nominal S&L tax rates.

The implementation of tax deductibility will have two effects on taxpayers. First, the income of itemizers will be increased and second, the "price" of S&L services to this group will diminish. We shall treat these in turn.

The income effects arising from tax deductibility are likely to be of minor importance. This is because the revenue losses caused by deductibility will have to be recouped.[10] It is impossible to say which federal taxes would be increased to recover the revenue loss, but let us suppose that the loss is made up by an accross-the-board increase in marginal income tax rates. While many itemizers will still be better off, it is clear that non-itemizers will be worse off. With the higher after-tax incomes, itemizers might be expected to support added public services. Non-itemizers, however, would tend to favor a smaller public sector. Consequently, the net effect on S&L services is uncertain. Whatever the net outcome, it is likely to be small. Thus, we can ignore the income effects of the deductibility provision.

Let us consider the "price" effects. After the adoption of deductibility, added S&L services will appear to be cheaper to itemizers because the federal government will share in the tax costs of the new services. In effect, the federal government becomes a partner in the finance of expanded S&L services. Thus, part of the S&L electorate, the itemizers, will be more responsive to an expansion of services. It is in this sense that deductibility constitutes a "subsidy" to S&L governments.

The quantitative significance of this subsidy is difficult to establish because of the paucity of consistent estimates of the price elasticity for total S&L expenditures. Indeed, the literature contains only a handful of estimates for total local expenditures and none whatever for state expenditure.[11] And the local estimates span the range of the credible, ranging from a high of -1.2 by Inman (1971) to a low of -.1 by Gramlich and Rubinfeld (1982). Making matters worse is the use of different "tax prices" by different investigators. Only Inman (1971) explicitly considers the effect of tax deductibility on tax price; the others use some variant of one's house value as a fraction of the total community tax base. Faced with this lack of data, Noto and Zimmerman (1983) use a rough average of price elasticities (-.5) for individual services -- which are much more consistent and available. Such a procedure overlooks the substitutability effects among public services, which would be absent for total expenditures. Thus, the (-.5) figure is biased upwards.

Existing estimates are also biased upwards because they include the effects of tax competition among jurisdictions -- which would be absent from a general decrease in tax prices as results from tax deductibility. Furthermore, they include income effects. The appropriate compensated elasticity would be approximately .1 less in absolute value than the incompensated elasticity.[12]

In my judgement, the above reasons call for a considerable reduction in the published price elasticity figures -- say by one-half. Thus, the price elasticity which is relevant for tax deductibility ranges from a high of (-.6) (Inmnan) to (-.05) (Gramlich and Rubinfeld). Noto and Zimmerman estimate that the average price reduction to the itemizers due to deductibility is 41%. Applying this to the range of elasticities above gives us an expenditure estimulus of between 2% and 24%. If we choose the mid-range of this interval as our best guess, we get an expansion of 13% in S&L expenditurtes because of deductibility. Even though the basis for the calculation is extremely crude, this figure suggests that tax deductibility may have a significant impact on the size of the S&L sector.

II. Tax Deductibility as an Inefficient Subsidy

Noto and Zimmerman (1983), using a price elasticity of -.5, argue that the increase in S&L expenditure caused by deductibility amounts to only 60¢ per dollar of loss to the federal treasury. Because the federal government has the option of giving the dollar to S&L government directly, say through Revenue Sharing, Noto and Zimmerman conclude that deductibility is an inefficient mechanism for stimulating S&L spending.

There are two flaws in this argument. If the price elasticity is indeed -.5, then S&L expenditure rises by 50¢ per dollar of foregone federal revenue. For the change in S&L expenditure is equal to $-E(\Delta p/p)e_p$, where e_p is price elasticity, $\Delta p/p$ is the price reduction to itemizers, and E is the original (prededuction) level of S&L expenditure. The cost to the federal government, on the other hand, is $E(\Delta p/p)$. The ratio of these two is clearly $-e_p$, and is independent of the size of the price reduction.

Using my own figures for e_p, we obtain an expenditure stimulus of 5¢ to 60¢ per dollar of federal expenditure. This appears to strengthen Noto and Zimmerman's inefficiency argument. Further inspection of the logic, however, raises some serious doubts about their hypothesis.

First, it should be noted that if we consider Revenue Sharing to be the alternative to tax deductibility, we no longer can decrease income tax rates in the face of the repeal of deductibility. To the average taxpayer, this means that his/her taxes will have risen by the average tax-saving from deductibility. Thus, repeal of deductibility will carry with it an income effect. This income effect will cause S&L taxpayers to reduce their demand for public services.

Second, the allocation of Revenue Sharing money to S&L governments does not guarantee that all such funds will remain with them. These governments have the option of reducing their taxes, in effect sharing some of the Revenue Sharing with the taxpayer.

The net effect of substituting tax deductibility by Revenue Sharing will depend, in part, upon the relative size of these two effects. And there are good theoretical reasons to suppose that these effects will exactly cancel out. Suppose, instead of giving the Revenue Sharing monies to S&L officials the federal government gave the money directly to the taxpayer. These monies would, in the aggregate, exactly match the tax increase caused by the repeal of deductibility.[13] Thus, taxpayers as a whole would be no worse off nor better off with respect to the income that they must allocate between private goods and S&L services. If follows that the only effect of the change that remains operative is an increase in the tax price that voters confront for incremental S&L services. Using the argument of the preceding section, the, S&L expenditures could be expected to fall by 2% to 24%. Contrary to Noto and Zimmerman, then, our reasoning suggests that tax deductibility may be more stimulative than Revenue Sharing.

Central to our argument is the hypothesis that General Revenue Sharing would have the same stimulative effect whether the monies are given to S&L governments or to S&L citizens. If voters are perceptive, it is reasonable to assume that this is the case because the total resources available to the community would be the same in either event. But there is not support for this proposition in the empirical literature on the determinants of S&L expenditures. Studies repeatedly find that general purpose grants, such as General Revenue Sharing, stimulate spending by a much greater amount than would a similar increase in community income. According to Gramlich and Galper, for instance, an unrestricted grant of $1 would increase spending by 43¢ while a $1 increase in income would raise spending by only 9¢. This disparity has come to be known as the "flypaper effect"--money sticks where it hits.

Various attempts have been made to reconcile the flypaper result with public choice models of budget determination. Some use "voter illusion" to explain the result, others bureaucratic control of the political agenda, and still others the deadweight losses of S&L taxes. None of these explanations, to date, have received widespread acceptance. The median voter paradigm to which the flypaper effect is inconsistent continues to dominate the public choice literature.

To some, including the author, the problem may involve the empirical estimates themselves. All of the estimates for General Revenue Sharing, for example, were based upon behavior during a period during which the growth rate of S&L taxation was undergoing a profound shift-- the decade of the seventies. It is not unreasonable to believe that many governments found themselves in a disequilibrium situation, trying to accomodate budgets to the changing demography and voter tastes. Revenue Sharing, in such a situation, could have helped to ease the period of transition to the lower growth track, allowing budgets to be larger than they would be in the new equilibrium setting. The widespread "taxpayer revolt" of the late seventies is ample evidence of the pressures put on S&L governments. For many governments, particularly central cities, the problem has continued into the eighties with the cutback of many federal social programs. Thus, it may be that, over time, the predictions of the median voter model will prevail.

The upshot of this discussion is that it would be imprudent to base an important policy change upon an empirical finding that is at odds with a model which enjoys widespread acceptance. To use an example, twenty years ago the preponderance of empirical work supported the hypothesis that, in the short-run, the corporation income tax was passed on to consumers -- a result totally at odds with the hypothesis of profit maximization. Over time, however, using different methods, economists have come to find that the burden of the corporation income tax falls upon owners of capital. By analogy, it seems premature to accept the flypaper hypothesis. Considerably more evidence is required before we should base policy upon this result.[14]

To conclude this section, it is not necessarily the case that tax deductibility will stimulate S&L spending by less than a program of General Revenue Sharing. Indeed, theoretical consideration suggest that the opposite may be true. In any event, the evidence is not sufficiently clear cut to conclude that tax deductibility is an inefficient form of subsidy to S&L governments. This is not to say that there are not grant mechanisms that could more effectively stimulate particular forms of S&L expenditures. But with respect to stimulating S&L expenditures in general, tax deductibility is not inherently inefficient.

IV. CONSEQUENCES AND CHARACTERISTICS OF THE FISCAL STIMULUS PROVIDED BY DEDUCTIBILILITY.

We now turn to the question of whether or not the stimulus provided to S&L spending by deductibility can be justified. In a world without spillovers among communites (externalities), without S&L redistributive activity, and in which all S&L services are financed through benefit taxation, the answer is an unequivocal no. Left to their own devices, S&L governments, in these circumstances, would provide an optimal level of public services. Tax deductibility would lead to over- consumption of S&L services.

As pointed out earlier, however, these circumstances do not correspond to reality. S&L governments provide a wide variety of services which are enjoyed by citizens who reside outside the boundaries of the providing jurisdiction. S&L government also engage in income redistribution activities and benefit taxation tends to be the exception rather than the rule. The consequence of each of these factors for the desirability of S&L taxes shall be discussed in turn.

First, consider externalities. For obvious reasons, S&L governments will underprovide services which generate externalities. Deductibility, by lowering the tax price of all services, will stimulate the provision of externality producing services. It has long been believed, however, that a more effective means of dealing with interjurisdictional externalities is through a set of conditional grants targeted towards those activities which produce externalities. While this position seems plausible in theory, it has fared less well in practice. The proliferation of conditional grants programs during the sixties and seventies resulted in an unwieldy morass of regulations and paperwork, substantially reducing the effectiveness of the grants. It is also now suspected that the federal bureaucracy, bound by rules of uniformity, is not capable of fine tuning a categorical grants program to account for significant differences among local situations. The result has been a gradual deemphasis of categorical grants in favor of "block" grants which can be used by recipient governments over a broad range of programs. The effect of block grants is not dissimilar to that of an unconditional grant such as General Revenue Sharing, because of the fungibility of resources. Hence, much of the ability to target federal resources towards externalities has been lost through blocking. It is not clear, therefore, that deductibility is a less effective means of dealing with externalities than its principal alternatives -- unconditional or block grants. While block grants may have some edge with respect to targeting in a broad sense, deductibility has the advantage of providing a price effect for stimulating spending.

Second, many S&L expenditure programs are explicitly or defacto redistributive in character.[15] Deductibility fosters spending on such categories. However, the conventional wisdom has held that income redistribution should be left to the federal government. This is because citizen mobility can thwart attempts to redistribute and because there is a national interest in redistribution. Here again, conventional wisdom flies in the face of reality. S&L governments do redistribute without lossing all of their population. Moreover, all levels of government have consistently chosen to provide much of their redistribution through in-kind transfer programs such as food, shelter, medical assistance, and subsidized public services. Among the last are below cost provision of police, fire, education, transportation, and a whole range of other services. These programs are precisely those provided by the S&L sector so that S&L governments must be part of the income redistribution process. But because the interest of those residing outside the jurisdiction providing the services are not taken into account, we tend to get too little S&L redistribution without federal intervention.

Just as in the case of externalities one can argue that such redistribution as is accomplished via deductibility could be more effectively achieved by a grant program targeted to the communities in which the poor reside. Here the argument is more telling because some of the benefits of deductibility accrue to communities where few poor live--e.g., affluent suburbs. Moreover, it should be relatively simple to define a grant formula which is targeted to the poor. Even so, at the state level, deductibility might come close to such a formula. For it is precisely those states who engage in vigorous redistribution to the poor, e.g., the Northeast, which obtain disproportionate benefits of deductibility. It may also be the case that the subsidy to wealthy suburban jurisdictions is not totally unwarranted for there are strong fiscal incentives for such communities to close their doors to the poor. The elimination of deductibility would serve to increase these forces. Even with these caveats, however, there are probably better ways of reditributing income to the poor than by the "trickling down" benefits provided through deductibility.

Third, let us consider the consequences of non-benefit taxation. The taxes used to finance S&L services will distort choices between work and leisure, consumption and saving, between taxed and non-taxed commodities, and, most importantly, of where to live. These distortions and their associated efficiency costs may be taken into account when deciding upon the level of S&L services. Since they increase the costs of public services they can be expected to lead to a smaller public sector than otherwise. Deductibility, by reducing the effective marginal rates of S&L taxes, is an effective way of dealing with this problem. While one might argue that the higher federal tax rates needed to finance deductibility also produce distortions, this has no bearing on the argument at hand. For no S&L government will consider its impact on federal tax revenues when making its expenditure decisions. Finally, there may be a consequence of the fiscal stimulus provided by deductibility that we have overlooked in the discussion thus far. The stimulus applies to any expenditure financed by S&L taxes. There is the incentive, therefore, to have S&L governments provide goods and services that would have normally been provided by citizens themselves in the private sector. Instead of paying for private dancing lessons one could have the school district provide dancing as a part of its extra-curriculum activities. Or one could have a golf course provided by a municipality instead of through a private country club. In such situations, citizen-voters trade off some loss of control over the quality of services for the tax savings provided by deductibility.

The extent to which this is a serious problem cannot be resolved without considerable time and effort not available to us. However, the existence of public recreational facilities such as golf or tennis, is not primae facie evidence of abuse of deductibility. It may be social policy to open up such activities to those with modest incomes. Indeed, the problem should arise only in connection with small, wealthy local jurisdictions where citizens can closely monitor the fiscal activities of their governments. It is difficult to imagine abuse in hard pressed central cities or in heterogeneous state jurisdictions.

To sum up this section, there are a number of legitimate reasons for promoting the expansion of S&L expenditures. In one case, the distortion caused by non-benefit S&L taxes, a general expansion is the objective.[16] In the other two cases, externalities and redistribution, expansion is necessary for only selected services. For redistribution could probably be done more effectively through a program of compensatory grants to jurisdictions with high incidences of poverty. For externalities, however, deductibility could be as effective as any alternative which is open to the federal government.

V. OTHER CONSEQUENCES OF THE REPEAL OF DEDUCTIBILITY.

A. Reduced Productivity.

The repeal of tax deductibility could be interpreted within the context of moving towards a flat income tax or modified flat income tax. That is, the additional revenues afforded by repeal could be used to lower marginal rates of the existing federal income tax. Since the efficiency or deadweight losses of a tax are an increasing function of its marginal tax rates, such a change would appear to promote productivity of resources.

This may not necessarily be the outcome, however. The repeal of deductibility would result in higher marginal rates of S&L taxes for itemizers and hence increase deadweight losses at the S&L level. Indeed, the net result may be to lower productivity. For one thing, the excess burden of a tax varies with the square of the marginal tax rate. Since the benefits of deductibility are concentrated on itemizers the increase in their marginal tax rates will be greater than the across the board decrease given to the population at large. Hence, net excess burden might rise. The result is uncertain because the mix of increased S&L taxes is different than a simple tax on income. For another, S&L taxes are not uniform across jurisdictions. Repeal of deductibility is tantamount to increasing marginal tax rates of S&L taxes in proportion to existing levels. This would lead to a reshuffling of population among jurisdictions and/or a general decrease in S&L expenditure, both leading to efficiency losses.[17]

For these reasons, the efficiency reasons given to justify flat-taxes in general do not apply in the case of the deductibility of S&L taxes.

B. Distort the Tax Structures of S&L Governments.

If the contemplated reform is to eliminate the deductibility of personal S&L taxes while continuing the deductibility of business taxes, one might expect S&L government to respond by increasing their emphasis on business taxes. Indeed, in the case of personal income taxes, the states could deny the federal government any revenue gain by shifting to factor taxes, such as a value-added tax or a payroll tax. Such taxes would be similar to income taxes except that they would be less progressive than most state income taxes now on the books.[18]

Interestingly, emphasis in existing studies has been given to the fact that, in the absence of deductibility, S&L governments would make greater use of user charges. This overlooks the continued deductibility of business taxes and the greater attraction such taxes would provide. And the incidence of business taxes is much less certain than for personal taxes, and may also seriously distort the spatial allocation of resources.

This consideration is not simply a theoretical curiosem. Recent work by Hettich and Winer (1984) has provided evidence that states respond to tax exporting in choosing their tax structures. These effects can be avoided only by denying the deductibility of business taxes. But such a change is neither likely nor desirable.

C. Incidence Effects.

As pointed out above, the elimination of tax deductibility is equivalent to imposing new S&L property, sales, and income taxes upon itemizers. The increase will be proportional to existing tax rates. In the case of property taxes, this amounts to an increase in property taxes upon homeowners -- because the set of itemizers is almost identical to the set of homeowners. The increase in homeowner taxes will be largest in central cities and in the Northeast -- jurisdictions that are already fiscally beleaguered. In the short run the burden will be upon such homeowners. Nationally, this will tend to increase the progressivity of the overall tax structure. Of course, the impact on a household of given income will depend upon where it is located. Thus, some higher income households will experience a smaller increase in property taxes than some lower income households. This detail is lost if one only considers national aggregates.

In the long-run, the burden of the higher tax on homeownership will be spread to those who own rental housing as well as other forms of capital. This reflects the tendency of the net returns to capital to be equalized. Since capital ownership is positively correlated with income, the result will remain a progressive incidence. However, there may be important excise effects to consider. Residents of high tax jurisdictions, renters as well as owners, will experience an increase in their housing costs, while the situation is reversed for low tax jurisdictions. This means that housing costs in the Northeast will rise relative to those of the South. Once again, the aggregate impact of the excise impacts--zero--masks important distributional effects. The poor in Northeastern cities will suffer higher housing costs while those in the South will enjoy lower housing costs.

A similar story can be told for income and sales taxes. In the short-run the incidence will bear disproportionately upon itemizers (homeowners) who live in high tax areas. In the long-run, such people will tend to migrate to lower tax areas. This will raise land costs and hence living costs in the recipient areas (opposite to property taxation) while lowering those in sending areas. Thus, the initial effects will be mitigated by migration.

In summary, the incidence effects of deductibility and its repeal are complex and involve effects such as changes in the costs of homeownership which are not obvious on the surface. In case of repeal, the burden, in the long run, of the higher S&L taxes will be felt by rich and poor alike, with the aggregate outcome exhibiting some increase in the progressivity of the tax structure. But the increase progressivity will not be uniform. Some well-to-do will benefit and some poor will lose. Some gain of vertical equity will be achieved by some loss of horizontal equity.

D. Effects on the Progessivity of S&L Tax Structures.

The effects of tax deductibility is to reduce the effective progressivity of S&L taxes because of the rising marginal tax structure of the federal income tax. Thus, a sales tax, which might be otherwise proportional in incidence, is converted into a regressive tax in net terms by deductibility. This will not go unnoticed by S&L officials. It will encourage then to choose tax rates structures as well as tax base definitions which will be more progressive than otherwise. If deductibility is eliminated so will be this incentive. Thus, the apparent increase in progressivity discussed in the last section may be offset by S&L governments' moving towards a more regressive tax structure.

VI. PARTIAL ELIMINATION OF TAX DEDUCTIBILITY

An alternative to outright repeal is to eliminate some portion of deductibility. Several ideas have surfaced. One is to place a cap on deductibility, another to put a floor under it. Still another is to repeal the deductibility of the sales tax

Let us start with sales taxes. Our argument, though, would apply to the elimination of either the two other taxes. We can find no coherent basis for such a reform. There is, at best, a weak relationship between the payment of sales tax and the receipt of public service benefits. An this relationship presumes a monotonic relationship between income (and hence purchases), on one hand, and public service benefits on another, As we argued in section II, such a well behaved relationship may not exist. More importantly, it does not exist across space. Some states do not even use a sales tax and most local governments do not. Even among those units that use a sales tax, the extent of use is extremely variable. Elimination of sales deductibility would make the present Federal Income Tax more inequitable.

It is also not clear that repeal of sales tax deductibility will have any effect upon the level of Federal subisdy flowing to S&L governments. For these governments have several options open to them: (1) increase reliance on income, property, and business taxes; (2) convert the sales tax to a value-added tax which is deductible. In either event the stimulus to _marginal_ S&L spending would not be materially reduced. Moreover, the revenue gain to the Federal Government would be significantly lessened.

The major effect of the proposal, then, would be to discourage the use of the sales tax as we now know it.

Next, consider a floor below the tax deduction. This could take the form of a flat dollar figure above which taxes are deductible or some percentage of income.

We consider the flat floor first. If set low enough, such a floor would not change the marginal incentives that currently exist to increase services. But it would still encourage S&L governments to shift to business taxes. With respect to tax equity a modest fixed dollar floor would constitute an improvement because all citizens enjoy some level of public service benefits. Thus, there is considerable merit to the idea of a floor if it is deemed desirable to maintain the spending and other incentives of present arrangements. In effect, a fixed dollar floor constitutes a lump-sum tax on itemizers. And such a tax would be progressive because the value of the floor is directly proportional to one's marginal tax rate. The floor could be computed as a percentage of average S&L financed expenditure upon non-redistributional programs.

A floor computed as a percentage of income would have many of the same attributes as a fixed dollar floor. Since S&L tax payments increase with income such an approach could yield greater revenue gains to the Federal Government and provide more progressivity. The difficulty, however, may be to find a percentage figure that does not remove a significant number of itemizers from those who enjoy marginal income tax reductions from the expansion of S&L expenditures. For this reason, it may be preferable to have a fixed dollar floor which grows over time with S&L spending.

A ceiling on tax deductibility, if chosen low enough, would remove virtually all incentive effects from the present system. All that would remain would be a redistribution of income from wealthy itemizers to less affluent itemizers and tax payers in general. While this would seem to be desirable on distribution grounds, i.e., it is more progressive than a floor, it creates similar horizontal inequities that full repeal would produce. In effect, it assumes that the only beneficiaries of S&L public services are those people that pay a good deal in taxes. Such an assumption seem untenable. If a ceiling is to be imposed, then, legislators would be best served by setting it at zero.

Thus, as a partial reform, a ceiling on deductibility has little to say for it. For it has the same incentive effects as total repeal but less fairness.

VII. CONCLUSIONS.

This brief survey of the consequences of S&L tax deductibility by households under the U.S. Personal Income Tax reveals them to be many, complex, and far reaching. It is unlikely that many of these effects were foreseen by the framers of U.S. Income Tax law, nor have some of them been considered by those who advocate reform.

Among our principal findings is that the equity case for total repeal is far from compelling. The connection between individual tax payments and service benefits is not a close one. This owes to the redistributive character of many S&L programs and the fact that poor are not uniformly spread among S&L jurisdictions. At best, equity arguments can be used to put a floor on tax deductibility, reflecting the fact that all enjoy some level of S&L service benefits.

Another conclusion challenges the growing belief that S&L tax deductibility is a less efficient means of aiding S&L governments than a system of Revenue Sharing and/or Block Grants. Such arguments tend to confuse the income and price effects of the spending stimulus provided by the alternative mechanisms. Unlike the grants approach, tax deductibility offers a price stimulus to spending.[19] Grants can be more effective only if they have a more powerful income effect; but here, the evidence is far from complete.

A third conclusion is that S&L governments may respond to the partial or total repeal of personal tax deductions by redirecting and redefining their tax systems towards business taxes. Sometimes the change will be cosmetic, only changing the locus of the tax payment. Other times it will be substantive, leading to distortion in resource allocation as well as highly uncertain incidence effects. This "loophole" will be very difficult to close so that lawmakers should be fully appraised of its existence.

Finally, repeal will add far less progressivity than is suggested by looking at the aggregate distribution of tax deductions across income classes. The increased effective rates of S&L taxes will be shifted towards rich and poor alike in other jurisdictions. Moreover, S&L governments may react by reducing the progessivity of their own tax structures.

Endnotes

[1] This estimate was taken from Noto and Zimmerman (1983).

[2] The very same argument can be made for property tax finance if the income elasticity of the demand for housing is unity. A qualitatively similar argument can be made for any degree of progression of the tax system; all that matters is that taxes and income are positively correlated.

[3] Let

$$q = D(p, I)$$
$$p = I/Y$$

where q = public service demand, p = tax price, I = income, and Y = community income, Then

$$dq/dI = q/I(E_I - E_p)$$

[4] This follows trivially from the fact that, at their prevailing tax price, the well-to-do have excess demand.

[5] This conclusion is based upon the assumption of declining marginal benefits from public services.

[6] Of course we might still have some problem of horizontal inequity; similarly situated individuals might enjoy widely different net fiscal benefits.

[7] Gramlich and Rubinfeld ((1982) allege to have found a "pro-rich" bias in the supply of local public services in Michigan. Such a bias, however, is

measured gross of tax paid and cannot be used to refute our contention here.

[8] The characterization of defensive outlays was first made by Bradford, Malt, and Oates (1969). For a further elaboration, see Hamilton (1983).

[9] For a discussion of the quantitative significance of such redistribution in large urban areas, see Oakland (1979).

[10] The repeal of deductibility could be viewed as a revenue measure and thus have income effects. But such an action should be evaluated as an alternative to other revenue enhancing measures -- e.g. raising tax rates. Hence, it is appropriate to abstract from income effects.

[11] For a survey of the literature see the companion piece by F.T. Sparrow (1985).

[12] The compensated and uncompensated elasticities differ by the product of the share of S&L expenditure in total income and the income elasticity of demand for public services. Assuming the latter to be unity and the former to be ten percent, we arrive at the reduction factor of .1.

[13] This argument abstracts from the distributional differences between a Revenue Sharing Program and tax deductibility.

[14] This argument is more than conjecture. Gramlich and Rubinfeld (1982)'s estimates imply that the "flypaper" result does not hold for Michigan in the early 80's. The effect of income on public spending is greater than the effect of unconditional grants.

[15] For an estimate of the quantitative significance of such redistribution, see Oakland (1976).

[16] With the exception of course, of publicly provided private services.

[17] This outcome reflects our working hypothesis that S&L taxes are not

benefit charges. If they are, the present system distorts the spatial allocation of resources and repeal would eliminate the distortion.

[18] One might think the states could also thwart repeal by shifting the legal liability of the retail sales tax from the consumer to the firm. This would not affect federal tax receipts, however, because the sales tax would become part of the firm's taxable receipts as well as a deductible expense.

[19] The present Revenue Sharing Program does have a price effect because of a tax effort component in the formula. Relative to tax deductibility, however, this incentive is small.

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Government Finance Officers Association

Policy Statement

Deductibility of State and Local Property, Sales and Income Taxes

The provision of the federal income tax code that allows taxpayers to deduct their state and local tax payments from their federal taxable income is a fundamental statement of the historical right of state and local governments to raise revenues and taxpayers not to be double taxed.

Deductibility preserves the ability of state and local governments to raise revenues and to provide services, promotes equity in the federal taxing system, discourages the migration of businesses and individuals for tax purposes, avoids excessive cumulative federal/state/local income tax rates, and preserves the autonomy of state and local governments.

The GFOA again urges the Congress and the Administration to recognize that states and local governments are not special interest groups, but are an integral part of the nation's total governmental structure of which the federal government is the other part.

For the reasons stated above, the Government Finance Officers Association (GFOA) opposes the elimination, in whole or in part, of the deductibility provision of the federal income tax code.

Adopted: May 28, 1985

STATE OF MISSISSIPPI
OFFICE OF THE GOVERNOR
JACKSON 39205

BILL ALLAIN
GOVERNOR

POST OFFICE BOX 139

June 24, 1985

Senator Dave Durenberger, Chairman
Subcommittee on Intergovernmental Relations
Committee on Governmental Affairs
United States Senate
432 Senate Hart Office Building
Washington, D. C. 20510

Dear Senator Durenberger:

Having read S. 315, a bill to modify the deduction of state and local taxes allowed under the Internal Revenue Code, I respectfully request the filing of a statement in your June 26, hearing thereon, as follows:

Mr. Chairman:

The principle of federalism that provides freedom to the citizens of state and local governments to raise taxes and spend money on the services that they need and want should not be abandoned in the name of tax reform.

Since 1913, we have adherred to the principle that Americans should not pay taxes on money already paid in taxes to another jurisdiction, and the claim now being advanced that the deduction of state and local taxes is an "unfair loophole" is not valid.

It has been alleged that two-thirds of Americans do not itemize, so they receive no benefit from the State and local tax deductions. In reality, however, that group of taxpayers benefits from the standard deduction, which has such tax deductions as a component. If the standard deduction is raised as proposed and the itemized deduction is removed as proposed, that so-called "loophole" is not closed, it is merely transferred from the "few" to the "many" as politically intended.

Those state and local taxes have gone for roads and bridges, fire and police protection, public schools and universities, medical services and water and sewer systems, and if the ability for homeowners and other taxpayers to deduct state and local taxes is removed or diminished, the price of those services will increase for those people.

That principle of federalism should not be compromised as intentioned by S. 315, and it should not be categorized with medical deductions. I do commend its author, however, for trying to retain some respect for the integrity of state and local tax bases.

State and local governments must be assured of adequate sources of revenue to meet their responsibilities, whether the capacity of each to do so be measured by per capita or otherwise.

If either the removal or a dimunition of the deduction of state and local taxes becomes law, that part of the legislation should not become effective until State Legislatures have an opportunity to provide for revenue losses.

Respectfully,

WILLIAM A. ALLAIN
GOVERNOR

WAA:gjp

APA American Planning Association
1776 Massachusetts Ave. NW
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Phone 202 872 0611

August 7, 1985

TO: Chairman and Ranking Minority Member of the:
  Senate Committee on Banking, Housing and Urban Affairs
  Senate Committee on the Budget
  Senate Housing and Urban Affairs Subcommittee
  Senate Committee on Energy and Natural Resources
  Senate Public Lands, Reserved Water and Resource Conservation Subcommittee
  Senate Committee on Environment and Public Works
  Senate Regional and Community Development Subcommittee
  Senate Committee on Finance
  Senate Committee on Governmental Affairs
  House Committee on Banking, Finance and Urban Affairs
  House Housing and Community Development Subcommittee
  House Committee on the Budget
  House Committee on Government Operations
  House Employment and Housing Subcommittee
  House Committee on Interior and Insular Affairs
  House National Parks and Recreation Subcommittee
  House Committee on Public Works and Transportation
  House Economic Development Subcommittee
  House Committee on Ways and Means

FROM: Frank Popper, Chairperson, National Policy Coordinating Committee
  Melvin R. Levin, AICP, Vice-Chairperson, National Policy Coordinating Committee

RE: POSITION OF THE AMERICAN PLANNING ASSOCIATION ON TAX REFORM

The American Planning Association and our 21,000 members--public officials, planning practitioners at all levels of government, and concerned citizens--share a commitment to the use of sound planning as a necessary ingredient in deciding how to develop, conserve and enjoy our communities and resources.

The American Planning Association is aware of the desirability of simplifying the Federal tax code. In general, we support those proposals which will result in higher taxes paid by corporations and by individuals in the highest income brackets. We understand that the President's tax reform proposals are intended to be revenue neutral, and that the net result should not be losses to state and local governments. Many of our members, however, are employed by state and local agencies. In those capacities they are involved in the delivery and the financing of public services. Planners are aware of the benefits government provides to all citizens, especially to those of low and moderate income. As such, we are concerned about the impact of the following proposals.

I. Deductibility of State and Local Taxes

A. APA opposes the elimination of the deductibility of state and local taxes on several grounds:

1. Deductibility has been a part of the Federal income tax system since it was instituted in 1913. Without this provision it is doubtful that state and local income taxes would have been instituted or would be as widespread as they are.

2. Without deductibility, individuals will be subject to Federal tax on earnings not retained by them, but paid to state and local governments.

3. Elimination of deductibility will affect middle-income taxpayers. 51% of tax returns using this deduction are for incomes less than $30,000. 87% are for incomes less than $50,000.

4. Elimination of deductibility may make state and local governments harder pressed to increase revenues at the same time that cuts in Federal support require them to be the prime providers of domestic services.

5. Elimination of deductibility may result in greater concentrations of poor and elderly people in high tax areas like older inner cities, exacerbating their problems of service provision and budget balancing. More affluent taxpayers can choose to live in lower tax suburban areas if they can no longer deduct high urban property taxes.

6. Elimination of deductibility may encourage state and local governments to raise revenues through less progressive sources such as user fees and other local taxes.

7. Elimination of deductibility may result in pressure to reduce social programs benefiting the neediest people (women and children, especially single parent families).

B. Alternatives to the elimination of deductibility are as follows:

1. Change the deduction to a tax credit; balance the revenue lost through maintaining this exception by continuing to tax individuals in the top income brackets at the existing 50% rate, rather than at the proposed 35% rate.

2. Place a ceiling on the amount of state and local income taxes deducted by individuals in the highest

brackets. For example, permit the deduction of only the amount of tax in excess of the amount of interest earned on nontaxable state and local bonds.

C. In summary, the APA believes that maintenance of the deductibility of state and local taxes is essential to maintain equity among taxpayers and among different areas of the country.

II. Tax Exempt Status of Municipal Bonds

A. The APA opposes terminating the tax exempt status of any municipal bond if more than one percent of its proceeds directly or indirectly benefit any person other than a state or local government, on the following grounds:

1. Many municipally owned facilities are operated by private management. Such facilities as airports, solid waste disposal sites, hospitals, and zoos may result in more than one percent of bond proceeds benefiting the private sector. But a clear majority of the investment benefits the general public.

2. State and local governments rely on tax exempt municipal bonds to finance such public facilities as water plants, mass transit systems, ports, and parking garages. Such financing is endangered by an excessively narrow definition of public purpose.

3. As cities have tried to cope with increases in operating deficits during the 1980's, they have found tax exempt industrial development bonds to be a good way to encourage industrial expansion, thereby strengthening their economic base.

B. Ways to ensure that tax exempt bonds are used for public purposes include requiring that:

1. The facility be publicly owned; or

2. The state or local government issuing the bond retain supervisory or operational control over the facility constructed with the bond; or

3. The state or local issuer make fur assets available to secure payment of a significant service on the bonds.

C. In summary, the APA supports continued tax exemption for municipal bonds which will be used to construct facilities which will be operated for the benefit of the general public.

III. Tax Provisions Relating to the Construction of Low Income Multifamily Rental Housing

A. The APA opposes the elimination of several provisions in the tax code which currently offer incentives to private developers to construct housing that can be rented at below market rates. These provisions include the following:

1. Multifamily housing bonds
2. Accelerated depreciation for rental housing under ACRS
3. Investment tax credits
4. Syndication benefits

B. The existence of these provisions, and, in particular, tax exempt mortgage subsidy bonds and special purpose industrial development bonds, has made possible accomplishments like those of the Ohio Housing Finance Agency, which was established in 1983, namely:

1. Creation of 4,500 construction jobs and 500 permanent jobs
2. Assistance to over 13,000 first-time homebuyers
3. Low interest mortgage loans to over 4,000 homebuyers in target areas, resulting in the revitalization of depressed neighborhoods
4. Development of over 2,000 units of housing for the elderly

C. The APA believes that the provision of housing for low and moderate income people is a legitimate governmental purpose. Most direct federal subsidies for such housing construction have been reduced or eliminated. This has made indirect subsidies through the tax code more important than ever. In addition, state governments have had to assume more responsibility for the provision of housing under the new federalism.

One way states have responded has been to use their constitutionally guaranteed right to issue tax exempt bonds to form public-private partnerships to construct new housing. States have also created housing finance agencies to monitor the administration and operation of such partnerships.

Without tax exempt housing bonds, states will be hard pressed to finance the construction of housing for low and moderate income people. In 1984 there were 7.5 million renter households below poverty level nationwide. Of these 23% or approximately 1.7 million were in subsidized housing. The remaining 5.8 million households are in need of assistance.

IV. Historic Preservation

A. The APA opposes the elimination of the Historic Preservation Tax Credit. This provision of the Economic Recovery Tax Act of 1981 has resulted in the following accomplishments nationwide:

1. $5 billion dollars of private investment has been made in more than 6,800 historic buildings.

2. These projects have been on a small, entrepreneurial scale. On 62% of the residential projects the investment has been less than $150,000. On 80% of the commercial projects it has been less than $1 million.

3. Older areas of the U.S. have enjoyed economic revitalization, as follows:

   a. Local economies have experienced a $4 billion increase in wages.

   b. An estimated 180,500 people have been put to work.

   c. More than $5.3 billion of local retail sales and business activity has been generated.

4. Since January 1982, more than 36,000 housing units have been rehabilitated. Of these, more than 18,500 rental housing units were created by converting underutilized and often abandoned commercial, educational and industrial buildings.

B. In summary, the APA believes that the historic preservation tax credit provides assistance to older urban areas struggling to achieve economic revitalization. It also encourages the preservation of irreplaceable historic buildings, which provides us with such long-term benefits as community pride, shared history, and enhanced quality of life.

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